Trust Decanting Tax Consequences
Navigating Income, Estate, Gift, and GST Tax Implications and Potential Safe Harbor Rules

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1pm Eastern    |    12pm Central   |   11am Mountain    |    10am Pacific

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I. Introduction

To date, seventeen states have enacted legislation that specifically allows a trustee to modify an otherwise irrevocable trust by transferring the assets of the trust to another trust. These statutes, known as decanting statutes, permit a trustee who has the discretionary authority to invade the principal of a trust (and in some cases trust income) to exercise that authority by transferring some or all of the assets of the existing trust to a new trust. In some cases, the dispositive or administrative provisions of the new trust will be identical to those of the existing trust; in other cases, they will vary.

The first state decanting statute, New York Estates Powers and Trusts Law Section 10-6.6(b), was effective on July 24, 1992. Since the enactment of the New York decanting statute, sixteen other states, including Alaska, Delaware, Florida, Tennessee, South Dakota, New Hampshire, North Carolina, Arizona, Nevada, Indiana, Missouri, Ohio, Kentucky, Virginia, Illinois, and Rhode Island have enacted similar-purpose statutes.

1 The author is licensed to practice in the State of New York. The information contained herein, together with all supplemental materials, was prepared based upon the author’s review and interpretation of the relevant statutes. As the author is not licensed to practice in the other states which have enacted decanting statutes, each person utilizing these materials is advised to consult with local counsel in each jurisdiction regarding the application and interpretation of each state’s particular statute.

3 12 Del. C. §3528.
4 Fla. Stat. §736.04117.
Decanting legislation is currently pending in Michigan\textsuperscript{18} and South Carolina.\textsuperscript{19} Decanting legislation has also been proposed by the Trust and Estates Section of the Colorado Bar Association.\textsuperscript{20} In addition, significant amendments to the Alaska statute have been proposed but are not enacted yet.

The rationale underlying a trust decanting is that a trustee who has the discretion to distribute trust property to or for the benefit of one or more beneficiaries of the trust has a special power of appointment over the trust property that allows the trustee to distribute the trust property not only outright to the beneficiaries of the first trust, but also to another trust for the benefit of one or more beneficiaries. As a result, under the majority of the state decanting statutes, the trustee’s power to appoint property to a new trust is expressly equivalent to the exercise by the trustee of a non-general power of appointment.\textsuperscript{21} Interestingly, only two state statutes (Indiana and Rhode Island) use the word “decanting” in their titles; most of the statutes refer to the trustee’s ability to distribute or appoint property in further trust.

The various decanting statutes differ in several ways, including: (i) the level of discretion that the trustee must hold with respect to the power to invade the trust (i.e., states that require the trustee to have absolute discretion to invade trust property versus states that permit a decanting if the trust contains distribution standards), (ii) whether a decanting may be based upon a power to invade trust income, (iii) the persons for whose benefit the power to invade the first trust may be exercised and the permissible beneficiaries of the second trust, (iv) limitations on the trustee’s exercise of the power that are intended to preserve certain tax benefits of the first trust such as marital and charitable deductions and gift tax annual exclusions, (v) restrictions on the ability of a beneficiary-trustee to decant, (vi) whether powers of appointment not granted under the first trust instrument may be granted to a beneficiary of the second trust, and (vii) the procedural aspects of the trustee’s exercise of the decanting power, including method of exercise, notice to beneficiaries and waivers of notice, beneficiary consent and court filing requirements.

\textsuperscript{8} N.C. Gen. Stat. §36C-8-816.1.  
\textsuperscript{10} 13 Nev. Rev. Stat. §163.556.  
\textsuperscript{11} Ind. Code §30-4-3-36.  
\textsuperscript{12} Mo. Rev. Stat. §456.4-419.  
\textsuperscript{13} Ohio Rev. Code Ann 5808.18 (2012).  
\textsuperscript{14} K.R.S. §386.175 (2012).  
\textsuperscript{16} 760 ILCS 5/§16.4 (2012).  
\textsuperscript{17} R.I. Gen. Laws §18-4-31 (2012).  
\textsuperscript{18} There are three decanting bills in Michigan. The bills are part of a single proposal but because the proposal affects three different statutes, legislative protocol in Michigan requires a separate bill for each affected statute. The bills passed the Michigan Senate on May 23, 2012 and have been sent to the House Committee on Judiciary, which will address them after summer recess.  
\textsuperscript{19} Decanting legislation was introduced in South Carolina on February 22, 2012 but has not passed either house. See Proposed S.C. Code §62-7-816A.  
\textsuperscript{20} It appears that the appropriate scope of the proposed Colorado decanting statute has been a subject of debate within the Colorado Bar. For example, the Family Law Section of the Colorado Bar Association recently voiced its opposition to the proposed statute on the grounds that it would allow trustees “to engage in divorce planning by changing or decanting property remainder interests into mere expectancies.” See, Colorado Bar Association Family Law Section May 2011 Newsletter (Greetings from the Chair).  
\textsuperscript{21} This is specifically provided for under all of the state decanting statutes except Illinois, Tennessee, New Hampshire and Missouri.
Most of the state decanting statutes use specific terms to refer to the original trust from which the assets are being appointed (i.e., first trust, invaded trust, original trust) and the new or receptacle trust into which the assets are being transferred (i.e., second trust, appointed trust, recipient trust). For purposes of this material, the terms “first trust” and “second trust” are used.

As a threshold matter, it should be noted that under all of the state decanting statutes, the power to distribute in further trust must be exercised by the trustee of the trust, not its beneficiaries or the trust’s creator. Where the trustee is also a beneficiary of the trust, some statutes, such as those enacted in Nevada, New York, New Hampshire, North Carolina, South Dakota and Missouri, specifically restrict (or even prohibit) a beneficiary-trustee’s ability to decant, particularly if doing so would result in adverse tax consequences to the trustee-beneficiary (see Section IV. below).

Each state’s decanting statute should apply to both testamentary and irrevocable inter vivos trusts that are governed by the law of that state, including trusts whose jurisdiction has been transferred to that state. The Delaware statute specifically applies to any trust that is administered in Delaware,\(^{22}\) and a trustee should be able to utilize the Delaware statute “whenever the trust is administered in Delaware even if some other jurisdiction’s laws govern the trust’s validity, construction and administration.”\(^{23}\)

All of the state decanting statutes make it clear that the trustee’s statutory authority to decant applies unless the instrument creating the first trust provides otherwise. Thus, a grantor who wishes to negate a trustee’s state law authority to decant should specifically do so under the terms of the trust instrument creating the trust.

Before undertaking a proposed decanting, the trustee should thoroughly review the trust instrument and confirm that it does not prohibit the trustee from acting. If the trust does not contain an express prohibition against decanting, the trustee should then determine if the trust instrument gives the trustee specific power to decant the trust. If the trust instrument is silent, then the trustee must determine whether the applicable state decanting statute is available taking into account the provisions of the first trust and the nature of the proposed changes. Care should be taken to ensure that the trustee’s power to appoint in further trust is exercised in accordance with the trust instrument, if applicable, or, if the decanting is effectuated pursuant to state law, all statutory requirements.

The trustee must also consider whether the proposed decanting is consistent with his fiduciary duties as trustee, particularly if beneficial interests in the trust will be modified or eliminated. A trustee owes duties of care, impartiality and loyalty to the beneficiaries of the trust, and must assess whether a proposed decanting is at odds with these duties. The trustee should also consider the grantor’s purpose in creating the first trust and whether the proposed decanting is contrary to that purpose.

Some decanting statutes make this a specific requirement of the trustee’s exercise of the decanting power. The New York statute, for example, provides that the trustee has a fiduciary

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\(^{22}\) 12 Del. C. §3528(f).

duty to exercise the power in the best interests of one or more of the beneficiaries of the invaded trust and as a prudent person would do under the prevailing circumstances. The New York statute also prohibits a trustee from exercising a power of invasion “if there is a substantial evidence of a contrary intent of the creator” and it cannot be shown that the creator’s intent would have changed under the current circumstances.

The New Hampshire statute states specifically that it does not abrogate the trustee’s duty (under § 564-B.8-801 of the New Hampshire Code) to distribute the trust property in good faith, in accordance with the trust’s terms and purposes and the interests of the beneficiary.

Under the South Dakota statute, the trustee of the first trust has an affirmative duty to determine whether the proposed appointment is necessary or desirable after taking into account the purposes of the first trust, the terms and conditions of the second trust, and the consequences of the distribution. The Virginia statute also states that the trustee’s exercise of the decanting power is subject to the fiduciary duties of the trustee of the first trust.

The following is a discussion of the relevant provisions of the various state decanting statutes.

II. **Scope of Trustee’s Invasion Power**

All of the state statutes permit a decanting where the trustee has the discretion to invade the principal of the first trust. The main difference among the statutes is the level of discretion that the trustee must hold – i.e., whether the trustee must have absolute discretion over trust distributions, or whether the trustee’s discretion to appoint the assets of the first trust may be exercised even if discretionary distributions are subject to a standard set forth in the first trust’s governing instrument.

In the vast majority of states, a trustee’s discretionary power to invade the first trust may be exercised even though the discretion is not absolute and unlimited but is limited by a standard. The three exceptions are the Florida, Indiana and Rhode Island statutes, which all require that the trustee have the “absolute power” to invade the principal of the first trust.

Under the Florida and Rhode Island statutes, a trustee does not have the absolute power to invade principal where distributions are limited to “specific or ascertainable purposes, such as health, education, maintenance and support.” However, the Florida and Rhode Island statutes make it clear that where the trustee has the power to invade trust principal for a beneficiary’s “best interest, welfare, comfort or happiness,” the trustee’s power is deemed to be absolute.

Under the Indiana statute, (i) “an absolute power to invade principal includes a power that is not limited to specific or ascertainable purposes such as health, education, maintenance and support” and (ii) the use of the word “absolute” to describe the trustee’s power to invade the principal of the first trust is not required.

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24 N.Y.E.P.T.L.§10-6.6(h).
25 Id.
As noted above, the remaining decanting statutes do not require that the trustee have an absolute or unlimited invasion power, but instead permit a trust to be decanted where the trustee’s distribution power is limited by a standard. However, many of these statutes also require that an invasion standard that appears in the first trust be included in the second trust.

The Alaska, Illinois, New York and North Carolina statutes specifically provide that if the trustee’s power to invade principal under the first trust is limited by a standard, the second trust must include the same standard and, in some of these states, the trustee’s power must be exercised in favor of the same current beneficiaries to whom a distribution could be made under the first trust.

Under the Arizona and Kentucky statutes, the standard included in the second trust must be the same as or more restrictive than the standard provided for in the first trust where the trustee exercising the distribution power is a possible beneficiary under the standard. If a beneficiary-trustee is not exercising the decanting power, then it would appear that no standard is required to be included in the second trust.

Under the Ohio statute, if the trustee’s power is limited by a standard, the trustee’s exercise of its discretionary distribution power will only be valid if the second trust does not materially change the interests of the beneficiaries of the first trust. If the trustee’s power is unlimited, then beneficial interests under the first trust can be materially changed (including eliminated) under the second trust.

Under the Virginia statute, where the first trust contains an ascertainable standard for distributions, the second trust must include the same standard unless a court approves a change in or elimination of the standard and the standard must be exercised in favor of the same current beneficiaries as is set forth in the first trust.

It should be noted that under the original New York statute, the trustee was required to have absolute discretion with respect to principal distributions under the first trust. This requirement was eliminated under the amended statute, which allows a New York trust that contains an ascertainable or other distribution standard to be decanted provided that the same distribution standard is included in the second trust. In addition, if the term of the first trust is extended under the second trust, then the New York statute requires that the same standard be included in the second trust but, in addition, permits the trustee to be given absolute discretion during the period of the extended term (i.e., at any time after the first trust would otherwise have terminated).

Although the Delaware statute does not require that a distribution standard set forth in the first trust be included in the second trust, it does require that the trustee’s exercise of the distribution power comply with any standard that limits the trustee’s authority to make distributions from the first trust. The trustee’s decanting power may be exercised whether or not the trustee would have been permitted to exercise the power to distribute all of the trust assets outright in compliance with the standard. Thus, if the first trust imposes a limit on annual principal distributions to beneficiaries, say a 5% distribution limit per year, the trustee’s exercise of the decanting power will be limited to only 5% of the assets of the first trust. If the first trust provides for distributions in the trustee’s discretion for health, education, maintenance or support, the second

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29 12 Del. C. §3528(a)(4).
trust must follow one or more, but not necessarily all, of those standards. Thus, the trustee may decant to a new trust solely for the education (but not the health, maintenance or support) of the beneficiary.

Under the Missouri statute, it appears that where trust distributions are subject to an ascertainable standard, and except if the trustee is participating in a change that is needed for a distribution to any beneficiary under an ascertainable standard, the trustee’s exercise of the power to appoint to a new trust may not remove restrictions on discretionary distributions imposed by the instrument creating the first trust.

As is discussed in Section IV below, certain decanting statutes require that the second trust contain a distribution standard in cases where a beneficiary-trustee is appointing the assets of the first trust, or where the trust beneficiaries have the right to exercise control over the trustees, such as the right to remove and replace the trustees of the first trust with related or subordinate parties to such beneficiaries.

In a number of states, a decanting power may be based on a trustee’s discretionary power to distribute trust income, not just principal. The Kentucky, Missouri, Nevada, North Carolina, South Dakota, South Carolina and Virginia statutes expressly permit the decanting of trust income or principal. The Arizona and New Hampshire statutes do not specifically distinguish between income and principal as they refer to the trustee’s power to make distributions under the first trust (which includes both income and principal).

Note that under the Alaska statute, the trustee must have the power to invade the principal of the first trust “for the benefit of a beneficiary who is eligible or entitled to the income of the trust.” Thus, it appears that under the Alaska statute, the trustee may not decant to a new trust for the benefit of a discretionary principal beneficiary who is not also an actual or potential income beneficiary of the first trust.

III. Permissible Beneficiaries of the Second Trust

One of the most difficult questions arising with respect to a trustee’s exercise of a decanting power 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. Typically, questions arise as to whether (i) current and remainder beneficiaries of the first trust may be eliminated as beneficiaries in the second trust, (ii) persons who were not beneficiaries under the first trust may be added as beneficiaries under the second trust, (iii) the interests of remainder beneficiaries under the first trust may be shifted to present interests under the second trust and (iv) powers of appointment not granted in the first trust may be granted to a beneficiary of the second trust.

All of the statutes require that at least one current beneficiary of the first trust be included as a current beneficiary of the second trust, and all of the statutes appear to allow the second trust to eliminate one or more beneficiaries of the first trust where the trustee has absolute discretion to distribute trust principal.

30 See Pulsifer, The Delaware Decanting Statute.
31 Id.
Under the Delaware and Tennessee statutes, the trustee’s power must be exercised in favor of the “proper objects” of the exercise of the trustee’s distribution power. The former New York statute also referred to the term “proper objects,” which appears to mean the persons to whom a current distribution of trust principal may be made under the first trust. In order to achieve greater clarity in identifying the class of permissible appointees of the trustee’s exercise of the decanting power, the more modern statutes refer to the beneficiaries of the first trust.

The approaches taken under the various decanting statutes are summarized below.

A. **Alaska**

Under the existing Alaska statute, the trustee’s power to invade principal must be exercised in favor of the beneficiaries of the first trust. The second trust may eliminate one or more beneficiaries of the first trust, but it may not add as beneficiaries persons who are not beneficiaries under the first trust.

B. **Arizona**

Under the Arizona statute, the trustee’s discretion must be exercised in favor of the beneficiaries of the first trust. The statute thus allows the elimination of beneficiaries of the first trust under the second trust, but not the addition of persons who are not beneficiaries of the first trust or the acceleration of remainder interests under the second trust.

C. **Delaware**

The Delaware statute provides that the trustee’s exercise of the authority to invade the principal of the first trust must be “in favor of a second trust having only beneficiaries who are proper objects of the exercise of the power.” Thus, although beneficiaries of the first trust may be eliminated in the second trust, the second trust may not include as beneficiaries persons who are not beneficiaries under the first trust. In addition, the interests of remainder beneficiaries of the first trust may not be accelerated to present interests under the second trust.

Although the second trust may not add new beneficiaries, it may grant a power of appointment (including a general power of appointment) to a beneficiary of the first trust that is exercisable in favor of any person, even if such person is not a beneficiary under the first trust. Since the potential appointees of the power of appointment do not have to be beneficiaries of the first trust, this provision effectively allows additional beneficiaries to be included under the second trust through the beneficiary’s exercise of the power of appointment.

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35 12 Del. C. §3528(a)(1).
36 12 Del. C. §3528(a).
D. **Florida**

Under the Florida statute, the trustee’s power to appoint the principal of the first trust to a second trust may be exercised for the current benefit of one or more of the beneficiaries of the first trust.\(^{37}\) The statute provides that the “beneficiaries of the second trust may include only beneficiaries of the first trust.”\(^{38}\) Thus, beneficiaries of the first trust may be eliminated under the second trust, but new beneficiaries may not be added in the second trust, and the interests of remainder beneficiaries of the first trust may not be accelerated under the second trust.

E. **Indiana**

Under the Indiana statute, the trustee’s exercise of the power to invade the principal of the first trust may be for the benefit of one or more beneficiaries of the first trust as long as one or more “beneficiaries of the second trust are the same as the beneficiaries of the first trust.”\(^{39}\) The second trust can thus eliminate beneficiaries of the first trust, but persons who were not beneficiaries of the first trust cannot be added as beneficiaries under the second trust, nor may the interests of remainder beneficiaries be accelerated to present interests under the second trust.

F. **Illinois**

The Illinois statute distinguishes between trustees who have absolute discretion and trustees whose discretion is limited. If the trustee has absolute discretion, then the beneficiaries of the first trust and the nature of their interests can be eliminated and/or changed in the second trust, but beneficiaries may not be added. In addition, the second trust can grant a beneficiary a power of appointment exercisable in favor of persons who are not beneficiaries of the first trust or the second trust.\(^{40}\)

If the trustee does not have absolute discretion, then beneficial interests cannot be eliminated or changed under the second trust and the same distribution standard that appears in the first trust must be included in the second trust.\(^{41}\) The second trust must also include any power of appointment granted under the first trust and it must be exercisable in favor of the same persons as provided for under the first trust.\(^{42}\)

G. **Kentucky**

Under the Kentucky statute, the beneficiaries of the second trust may include only beneficiaries of the first trust.\(^{43}\) Thus, beneficial interests may be eliminated under the first trust, but new beneficiaries may not be added under the second trust. The statute specifically

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\(^{37}\) Id.
\(^{38}\) Id. at (1)(a)(1).
\(^{39}\) Ind. Code §30-4-3-36(a)(1).
\(^{40}\) 760 ILCS 5/§16.4(c).
\(^{41}\) 760 ILCS 5/§16.4(d).
\(^{42}\) Id.
\(^{43}\) K.R.S. §386.175(4)(a).
prohibits the second trust from accelerating the interests of remainder beneficiaries of the first trust.\footnote{44}{K.R.S. §386.175(4)(b).}

Although the second trust may not add new beneficiaries, it may grant a power of appointment to a beneficiary of the first trust that is exercisable in favor of any person, even if such person is not a beneficiary under the first trust or the second trust.\footnote{45}{K.R.S. §386.175(i).} Since the potential appointees of the power of appointment do not need to be beneficiaries of the first trust, this provision allows additional beneficiaries to be included under the second trust through the beneficiary’s exercise of the power of appointment.

Any power of appointment granted in the second trust is expressly subject to Kentucky law covering the time at which the permissible rule against perpetuities begins and the law that determines the permissible period of the rule of the first trust.\footnote{46}{Id.}

H. Missouri

Under the Missouri statute, the second trust may have as beneficiaries only one or more of those beneficiaries of the first trust: (i) “to or for whom any discretionary distribution may be made from the first trust and who are proper objects of the exercise of the power” or (ii) “to or for whom a distribution of income or principal may have been made in the future from the first trust at a time or upon the happening of an event specified under the first trust.”\footnote{47}{Mo. Rev. Stat. §456.4-419.2(1).}

The statute thus permits the elimination of beneficiaries of the first trust and prohibits persons who do not have either a current or a future beneficial interest in the first trust from being added as beneficiaries under the second trust. Notably, the Missouri statute permits the acceleration of a beneficiary’s interest from a remainder interest under the first trust to a current interest under the second trust.\footnote{48}{Id.}

I. Nevada

Under the Nevada statute, the trustee’s power to distribute trust property may be exercised in favor of a second trust for the benefit of one or more of the beneficiaries of the first trust.\footnote{49}{13 Nev. Rev. Stat. §163.556(2)(a).} The second trust may not include a beneficiary who is not a beneficiary of the first trust.\footnote{50}{Id.} However, a permissible appointee of a power of appointment exercised by the beneficiary of the second trust is not considered a beneficiary of the second trust.\footnote{51}{Id.}

Although additional beneficiaries may not be added in the second trust, the Nevada statute does permit the second trust to grant a power of appointment (including a general power of appointment) to one or more beneficiaries of the second trust. This provision allows

\footnote{44}{K.R.S. §386.175(4)(b).}
\footnote{45}{K.R.S. §386.175(i).}
\footnote{46}{Id.}
\footnote{47}{Mo. Rev. Stat. §456.4-419.2(1).}
\footnote{48}{Id. The South Dakota statute similarly allows the acceleration of remainder interests to present interests.}
\footnote{49}{Id.}
\footnote{50}{13 Nev. Rev. Stat. §163.556(2)(a).}
\footnote{51}{Id.}
persons who are not beneficiaries under the first trust to be added by decanting to a second trust that
gives a beneficiary the right to include such persons as beneficiaries pursuant to the exercise of the
power of appointment.

J. **New Hampshire**

Under the New Hampshire statute, the second trust must be for the benefit of
one or more of the beneficiaries of the first trust.\(^{52}\) The statute specifically provides that the second
trust may not include a beneficiary that is not a beneficiary of the first trust.\(^ {53}\) The permissible
appointee of a power of appointment held by a beneficiary of the second trust is not considered to
be a beneficiary of the second trust.\(^ {54}\)

Thus, the statute permits the elimination of beneficiaries of the first trust, but
prohibits the second trust from adding persons who were not beneficiaries of the first trust or
accelerating remainder interests to present interests under the second trust.

Note that the New Hampshire statute does not specifically authorize the
granting of a power of appointment to a beneficiary of the second trust.

K. **New York**

In determining the identity of the permissible beneficiaries of the second
trust, the New York statute distinguishes between trustees who have unlimited discretion to invade
the principal of the first trust and trustees whose discretion is limited.\(^ {55}\)

Unlimited discretion is defined as an unlimited right to distribute principal
that is not modified in any manner, but word such as best interests, welfare, comfort or happiness, if
used in the first trust, are not considered a limitation or modification of a trustee’s right to distribute
principal.\(^ {56}\)

1. **Trustees with Unlimited Discretion.** A trustee with unlimited
discretion to invade principal can appoint part or all of the principal of the first trust for the benefit
of any one or more (including all) of the current beneficiaries of the first trust.\(^ {57}\) In addition, the
successor and remainder beneficiaries of the second trust may be any one or more (including all) of
the successor and remainder beneficiaries of the first trust.\(^ {58}\)

Thus, where the trustee has unlimited discretion, current, successor
and remainder beneficiaries of the first trust may be excluded from the second trust. Additional
beneficiaries, however, may not be included in the second trust, nor may remainder interests under
the first trust be accelerated to present interests under the second trust.

\(^{52}\) *Id.*


\(^{54}\) *Id.*

\(^{55}\) N.Y.E.P.T.L. § 10-6.6(b) and (c).

\(^{56}\) N.Y.E.P.T.L. § 10-6.6(s)(9).

\(^{57}\) N.Y.E.P.T.L. § 10-6.6(b).

\(^{58}\) *Id.*
A trustee with the unlimited discretion to invade principal may also grant a discretionary power of appointment (including a presently exercisable power of appointment) to one or more current beneficiaries of the first trust, provided that the beneficiary receiving the power of appointment could receive the entire principal of the trust outright under the terms of the first trust.\(^{59}\) In such a case, the New York statute requires that the power of appointment be unlimited and exercisable in favor of anyone in the world.\(^{60}\) The only exception is that the power of appointment may be limited in order to avoid the beneficiary, the trust creator or the creator’s spouse from having a general power of appointment with respect to the assets of the second trust.\(^{61}\)

If the trustee of the first trust has unlimited discretion, any power of appointment granted under the first trust may also be included in the second trust provided that it is exercisable in favor of the same class of permissible appointees and in the same manner as provided in the first trust.\(^{62}\)

2. Trustees With Limited Discretion. If the trustee of the first trust does not have unlimited discretion to invade principal, the current beneficiaries of the second trust must be the same as the current beneficiaries of the first trust, and the successor and remainder beneficiaries of the second trust must be the same as the successor and remainder beneficiaries of the first trust.\(^{63}\) Thus, current and future beneficiaries of the first trust may not be eliminated in the second trust where the trustee has limited discretion.

In addition, where the trustee has limited discretion, any power of appointment granted to a beneficiary of the first trust must be included in the second trust and the class of permissible appointees under the second trust must be the same as under the first trust.\(^{64}\)

L. North Carolina

Under the North Carolina statute, the beneficiaries of the second trust may include only beneficiaries of the first trust.\(^{65}\) Thus, beneficiaries of the first trust can be eliminated in the second trust, but the second trust may not add persons who are not current beneficiaries of the first trust. Where a trustee’s discretion is subject to an ascertainable standard, it appears that current beneficiaries of the first trust cannot be eliminated under the second trust, but that future beneficiaries can be eliminated.

The statute also specifically prohibits the acceleration of the interest of a beneficiary who has only a future beneficial interest (vested or contingent) in the first trust to a present interest in the second trust.\(^{66}\)

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\(^{59}\) Id. at (b)(1).
\(^{60}\) Id. at (b)(2).
\(^{61}\) Id.
\(^{62}\) Id. at (b)(3).
\(^{63}\) Id. at (c).
\(^{64}\) Id. at (c)(4).
\(^{65}\) N.C. Gen. Stat. §36C-8-816.1(c)(1).
\(^{66}\) Id. at (c)(2).
The second trust may grant a power of appointment to a beneficiary of the first trust to whom the trustee has the power to distribute principal or income. In such a case, the permissible appointees of the power of appointment may include persons who are not beneficiaries of the first or the second trust. This provision thus permits the addition, through the beneficiary’s exercise of the power of appointment, of persons who were not beneficiaries under the first trust. The granting of a power of appointment under the second trust, however, may not extend the permissible period of the Rule Against Perpetuities applicable to the first trust.

M. **Ohio**

Similar to the approach taken under the New York statute, the Ohio statute distinguishes between trustees who have absolute power to invade the principal of the first trust and trustees whose discretion is limited in determining the identity of the permissible beneficiaries of the second trust.

1. **Trustees with Absolute Power.** If a trustee has the absolute power to invade principal, he can appoint all or part of the principal, and all or part of the income that is not currently required to be distributed to any beneficiary, to the trustee of a second trust for the benefit of one or more current beneficiaries of the first trust.

   Thus, where the trustee has absolute power, current, successor and remainder beneficiaries of the first trust can be eliminated under the second trust. Additional beneficiaries, however, may not be included, nor may remainder interests be accelerated.

   A trustee with the absolute power to invade principal may also grant a discretionary power of appointment (including a general power of appointment) to one or more current beneficiaries of the first trust. The power can be exercisable in favor of any person, regardless of whether such person is a beneficiary of the first trust or the second trust.

   If the first trust permits discretionary distributions to be made to charitable organizations (either at the discretion of the trustee or by a third party directing the trustee), such charitable organizations are considered beneficiaries of the first trust.

2. **Trustees Without Absolute Power.** If the trustee of the first trust does not have absolute power to invade trust principal, then the second trust may not materially change the interests of the beneficiaries of the first trust. Thus, the interests of current and future beneficiaries of the first trust may not be eliminated or materially modified.

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67 Id. at (c)(8).
68 Id.
69 O.R.C. §§5808.18(A)(1) and (B).
70 O.R.C. §5808.18(A)(1).
72 Id.
73 O.R.C. §5808.18(A)(5).
74 O.R.C. §5808.18(B).
Note that the trustee’s decanting power can be exercised regardless of whether there is a current need to distribute trust principal under any standard set forth in the first trust.\textsuperscript{75}

\textbf{N. Rhode Island}

Under the Rhode Island statute, the trustee’s decanting power may be exercised in favor of one or more of the beneficiaries of the first trust, but the beneficiaries of the second trust may include only beneficiaries of the first trust.

Thus, the Rhode Island statute permits the second trust to eliminate persons who are beneficiaries under the first trust, but persons who are not beneficiaries of the first trust may not be added as beneficiaries under the second trust.

\textbf{O. South Dakota}

Under the South Dakota statute, the second trust may only have as beneficiaries one or more of the beneficiaries of the first trust: (a) to or for whom a discretionary distribution of income or principal may be made from the first trust\textsuperscript{76} or (b) to or for whom a distribution of income or principal may be made in the future from the first trust at a time or upon the happening of an event specified under the first trust.\textsuperscript{77}

The South Dakota statute thus permits the elimination of beneficiaries of the first trust but prohibits persons who do not have either a current or a future beneficial interest in the first trust from being added as beneficiaries under the second trust. Most notably, the statute expressly permits the acceleration of a beneficiary’s interest from a remainder interest under the first trust to a present interest under the second trust.\textsuperscript{78}

The second trust may grant a power of appointment to one or more beneficiaries of the second trust. The power of appointment can be a general power of appointment with respect to the holder, or a special power exercisable in favor of any other person, even if that person is not a beneficiary of the first trust or the second trust.\textsuperscript{79}

\textbf{P. Tennessee}

Under the Tennessee statute, The trustee’s power of invasion must be exercised in favor of the “proper objects” of the exercise of the power.\textsuperscript{80} The term proper objects is not defined in the statute, but should allow distributions only for the benefit of those persons who are currently entitled to receive distributions of principal under the first trust. Thus, it appears that additional beneficiaries may not be included in the second trust and remainder interests under the first trust may not be accelerated to present interests under the second trust.

\textsuperscript{75} Id.
\textsuperscript{76} S.D. Codified Laws §55-2-15(1)(a).
\textsuperscript{77} S.D. Codified Laws §55-2-15(1)(b).
\textsuperscript{78} Id.
\textsuperscript{79} S.D. Codified Laws §55-2-15(1).
Q. **Virginia**

Under the Virginia statute, the beneficiaries of the second trust may only include beneficiaries of the first trust.\(^81\) If the trustee’s distribution power is subject to an ascertainable standard, then the trustee must exercise his distribution power in favor of the same current beneficiaries as set forth in the first trust.\(^82\) In addition, the same ascertainable standard must be included in the second trust unless a court approves a change in (or the elimination of) the standard.\(^83\)

Thus, where the trustee has absolute discretion, current beneficiaries of the first trust can be eliminated in the second trust, but where the trustee’s distribution power is limited to an ascertainable standard, they cannot be eliminated.

In all events, additional beneficiaries may not be added and the Virginia statute expressly prohibits the trustee from accelerating a remainder interest in the first trust to a present interest under the second trust.\(^84\)

Although the second trust may not add new beneficiaries, it may grant a power of appointment (including a general power of appointment) to a beneficiary of the first trust that is exercisable in favor of any person, even if such person was not a beneficiary under the first trust.\(^85\) Since the potential appointees of the power of appointment do not need to be beneficiaries of the first trust, this provision allows additional beneficiaries to be included under the second trust through the beneficiary’s exercise of the power of appointment. The power of appointment will, however, be subject to the rule against perpetuities applicable to the first trust.\(^86\)

**IV. Limitations on Exercise of Trustee’s Power**

The state decanting statutes also contain provisions that are intended to shield the trust and the beneficiaries from certain adverse tax consequences. These include provisions that are intended to preserve certain tax benefits of the first trust such as marital and charitable deductions, provisions that limit the ability of a trustee-beneficiary to decant a trust, provisions that prevent the trustee from eliminating or reducing certain vested rights of the trust beneficiaries, and provisions that prevent the second trust from extending the permissible period of the rule against perpetuities applicable to the first trust.

A. **Income, Annuity and Unitrust Interests**

All of the state decanting statutes specifically prohibit a trustee’s exercise of a decanting power if it would reduce a beneficiary’s fixed or mandatory income interest, although under the Delaware, South Dakota and Missouri statutes, this limitation applies only if the first trust is a marital trust.

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\(^{81}\) VA Code Ann. §55-548.16:1(C)(1).  
\(^{82}\) VA Code Ann. §55-548.16:1(C)(2).  
\(^{83}\) Id.  
\(^{84}\) VA Code Ann. §55-548.16:1(C)(3).  
\(^{85}\) VA Code Ann. §55-548.16:1(C)(8).  
\(^{86}\) Id.
The more modern statutes, such as those in Arizona, Florida, Indiana, Illinois, Kentucky, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island and Virginia also prohibit the reduction or elimination of annuity or unitrust interests. Note, however that (i) in Delaware, only unitrust interests under marital trusts cannot be reduced or eliminated, (ii) in Missouri this prohibition applies where the first trust is a marital trust, a charitable remainder trust (“CRT”), a grantor retained annuity trust (“GRAT”) or a trust holding sub-S shares, and (iii) in South Dakota this applies to CRTs and GRATs.

Under the Illinois, Nevada, New Hampshire, New York and Ohio statutes, only current income interests, not future income interests are protected. Prior to the amendment of the New York statute, one question was whether fixed income interests arising in the future could be eliminated. The correct view would appear to be that only current income, unitrust and annuity interests should be protected. Note, however, that the Kentucky statute protects both current and future income, annuity and unitrust interests.

B. Rights of Withdrawal

Many of the decanting statutes also prevent the reduction or elimination of rights of withdrawal that are held by beneficiaries of the first trust.

Under the New Hampshire statute, the decanting power does not apply to such property. Under the Missouri, Nevada and South Dakota statutes, the decanting power does not apply unless the beneficiary’s power of withdrawal under the first trust is unchanged in the second trust.

Under the Delaware statute, the decanting power does not apply to a presently exercisable right of withdrawal held by a person who is the only beneficiary to or for whose benefit distributions may be made under the first trust.

Under the Kentucky, North Carolina and Virginia 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.

The Illinois, New York and Ohio statutes prohibit the elimination of a beneficiary’s current right to withdraw a specified amount or percentage of trust principal. These statutes also protect a beneficiary’s right to receive mandatory principal distributions under the first trust.

C. Tax Deductions and Exclusions

Marital and charitable deductions are specifically protected under the Florida, Indiana, Illinois, Kentucky, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island and Virginia statutes. In these states, the second trust cannot include any provision which, if included in the first trust, would have prevented it from qualifying for such deduction. Under the Ohio statute, the second trust also cannot omit any such provision.

Contributions qualifying for the gift tax annual exclusion are specifically protected under the Illinois, Nevada, New Hampshire and New York statutes. Again, the second
trust cannot include any provision which, if included in the first trust, would have prevented it from qualifying for such deduction.

Under the Delaware, Illinois, Kentucky, Missouri, Nevada, North Carolina, Ohio, South Dakota and Virginia statutes, where contributions qualified for the gift tax annual exclusion under IRC 2503(b) based on the first trust’s qualification as a 2503(c) trust, 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.

Under the Arizona statute, the proposed decanting cannot adversely affect the tax treatment of the first trust, the trustee, the settlor or the beneficiaries. The Illinois and New York statutes similarly prohibit a decanting where it would jeopardize any tax benefit of the first trust.

The Illinois, Kentucky, and Ohio statutes also specifically protect trusts for which sub-S elections have been made.

Interestingly, both the New York and Illinois statutes make it clear that grantor trust status is not a tax benefit and thus a decanting can be undertaken to change a trust from a grantor trust to a non-grantor trust and vice versa.

D. Beneficiary-Trustees

Many of the state decanting statutes also contain provisions limiting the ability of a beneficiary-trustee to act. Most of these provisions are intended to avoid unintended gifts by a beneficiary-trustee, including the application of Treas. Reg. § 25.2511-1(g)(2), which provides that if a trustee is also a beneficiary, the trustee’s distribution of trust property will constitute a taxable gift unless the distribution is limited by an ascertainable standard relating to health, education, maintenance or support.

Under the New York, North Carolina and Virginia statutes, a beneficiary-trustee is not authorized to act. These statutes provides that the power to appoint in further trust must held by a trustee who is not a current or future potential income or principal beneficiary of the trust.

Under the North Carolina and Virginia statutes, where all of the trustees are beneficiaries of the first trust, the statute specifically authorizes judicial appointment of a special fiduciary to exercise the power to appoint to a new trust.

Under the Arizona statute, if distributions under the first trust are limited by an ascertainable standard, and if the trustee exercising the distribution power is a possible beneficiary under the standard, the second trust must contain the same or a more restrictive standard.\textsuperscript{87} If a beneficiary-trustee is not exercising the decanting power, then any standard set forth in the first trust is not required to be included in the second trust.

The Arizona statute also provides that the trustee’s power to appoint in further trust may not adversely affect the tax treatment of the first trust, the trustee, the settlor or the beneficiaries. Thus, where a trustee-beneficiary’s power to appoint in further trust would adversely affect the beneficiary-trustee (such as where a gift under Treas. Reg. § 25.2511-1(g)(2) would result), the trustee cannot act.

Under the Nevada and New Hampshire statutes, a beneficiary-trustee may not exercise the power to appoint property of the first trust (i) if, under the terms of the first trust or local law the beneficiary-trustee does not have discretion to make distributions to himself or is limited by an ascertainable standard, or (ii) the beneficiary-trustee’s power to make distributions to himself requires the consent of a co-trustee or person holding an adverse interest and the second trust does not limit distributions to the beneficiary-trustee to an ascertainable standard and is exercisable without consent. In addition, if the first trust does not permit the beneficiary-trustee to make trust distributions to discharge his legal support obligations, the second trust must also limit the trustee’s discretion.

Practitioners should also be aware of restrictions on decanting where beneficiaries of the second trust have the right to remove and replace trustees. The Missouri, Nevada, New Hampshire and South Dakota statutes require that the second trust contain an ascertainable standard for distributions where the beneficiaries have the right to remove and replace trustees with a related or non-subordinate party to the beneficiary.

The South Dakota statute limits the ability of a beneficiary-trustee (known as a “restricted trustee”) to act. A trustee of the first trust is a restricted trustee if the trustee is a beneficiary of the first trust or if a beneficiary has the power to change the trustees to name himself or a related or subordinate party as trustee of the first trust. The limitations imposed on a restricted trustee only apply if either a trustee or a beneficiary who may change the trustee is a United States citizen or domiciliary, or the trust owns property that would be subject to United States estate or gift tax if owned directly by such person.

A restricted trustee of the first trust cannot exercise a discretionary distribution authority if doing so could have the effect of: (i) benefiting the restricted trustee as a beneficiary unless the exercise is limited to an ascertainable standard based on HEMS; (ii) removing restrictions on discretionary distributions to a beneficiary under the first trust unless distributions under the second trust are limited by a HEMS standard; or (iii) increasing the distributions that can be made from the second trust to the restricted trustee or to beneficiaries who can remove and replace the trustees with related or subordinate parties, unless the exercise of such authority is limited by a HEMS standard. Actions that cannot be taken by a restricted trustee may be taken by the unrestricted trustee of the first trust.

88 S.D. Codified Laws §55-2-15(2).
89 S.D. Codified Laws §55-2-15.
93 S.D. Codified Laws §55-2-15(3).
94 S.D. Codified Laws §55-2-16.
G. Most of the state statutes also contain provisions relating to whether the duration of the second trust may extend beyond the rule against perpetuities period applicable to the first trust (which is measured from the date that the first trust became irrevocable). The consequences of an extension of the permissible perpetuities period of the first trust through a trust decanting can have significant implications, particularly if the trust is grandfathered from the generation skipping transfer tax.

V. Statutory Mechanics: Manner of Exercise, Notice, Consent, Court Filings

A. Manner of Exercise

Most of state decanting statutes, including Delaware, Florida, Illinois Indiana, Kentucky, New York, North Carolina, Ohio, Rhode Island, South Dakota and Virginia require that the trustee’s decanting power be exercised by a written instrument that is signed and acknowledged by the trustee and filed with the records of the first trust (and the second trust in Illinois). In Nevada the trustee’s written instrument does not have to be acknowledged. The Alaska, Arizona, Missouri and New Hampshire statutes are all silent on the manner of exercise.

Questions also arise as to whether the second trust must be established under a separate trust instrument, or whether it can be created by the trustee under the first trust instrument. The Alaska and South Dakota statutes specifically require that a new governing instrument be created. The Arizona, Delaware, Florida, Indiana, Missouri, North Carolina, Ohio and Tennessee statutes specifically authorize the trustee to establish the second trust under the first trust.

B. Notice

Some states impose a mandatory notice requirement on the beneficiaries of the first trust, while in other states notice may be given in the discretion of the trustee.

The Florida, Indiana, North Carolina, Rhode Island and Virginia statutes all require 60 days advance notice to the beneficiaries of the first trust. The Ohio statute requires 30 days advance notice to all beneficiaries of the first trust and the South Dakota statute requires 20 days advance notice.

Under the Illinois statute, 60 days advance notice must be given to all legally competent current beneficiaries and presumptive remainder beneficiaries of the first trust (all as determined on the date the notice is sent). If the trust has a current charitable beneficiary or presumptive remainder beneficiary, notice must also be sent to the Attorney General.

The Kentucky statute requires 60 days advance notice to current beneficiaries of the first trust and to all beneficiaries in the oldest generation of remainder beneficiaries of the first trust. The Missouri statute requires 60 days advance notice to all permissible distributees and qualified beneficiaries of second trust.
In New York, notice must be served on the beneficiaries of the first trust (interested persons), the trust creator, if living, and all persons with a right to remove or replace the trustee exercising the decanting power.

The New Hampshire and Illinois statutes also require notice to the Director of Charitable Trusts or the Attorney General where the first trust has a current or future charitable beneficiary.

In Nevada, the trustee is specifically authorized (but not required) to give notice to the trust beneficiaries. The Delaware statute does not require any notice to any person.

Most of the statutes are silent on what constitutes adequate notice. At a minimum, the beneficiaries should receive a copy of the instrument exercising the decanting power. Under the New York statute, the beneficiary must receive not only a copy of the instrument of decanting, but also copies of the trust instruments creating the first trust and second trust. Under the South Dakota statute, the notice requirement is satisfied if a beneficiary receives a copy of the decanting instrument and the second trust agreement. Under the Florida, Indiana, Kentucky, North Carolina and Rhode Island statutes, serving a copy of the proposed instrument exercising the decanting power is sufficient.

Interestingly, few of the statutes address what provisions the decanting instrument should contain. The one requirement in New York is that the instrument must specify whether all or only some portion of the assets of the first trust are being appointed to the second trust.

The Florida, Indiana, Kentucky, Nevada, North Carolina, Ohio, Rhode Island and South Dakota statutes all allow a beneficiary to specifically waive the notice period, in which case the decanting will be effective prior to the expiration of the notice period. New York allows the beneficiaries to accelerate the effective date of the decanting, which is 30 days from the date that the serving of notice is complete. In Illinois, the decanting will be effective 60 days after notice is sent unless the notice period is accelerated.

The Missouri and Virginia statutes allow the beneficiaries to waive notice itself.

Although court approval is not required under any of the statutes other than Ohio (in the case of a testamentary trust created by an Ohio domiciliary), the New York statute does have a court filing requirement. An original of the instrument of decanting and copies of the instruments creating the first and second trust be filed in the court having jurisdiction over the first trust. However, in the case of a trust which has not been the subject of a prior proceeding in the Surrogate’s Court (i.e., an inter vivos trust) no court filing is required.

The New York statute also provides that a person interested in the first trust may object to the trustee’s exercise of the decanting power by serving a written notice of objection on the trustee prior to the effective date of the decanting. The statute also makes it clear that a beneficiary’s failure to object does not constitute consent, and does not foreclose the beneficiary’s right to object in the future, such as in a proceeding for settlement of an accounting of the trustee(s) of the first trust.
The Florida, Indiana and North Carolina statutes also make it clear that notice does not limit the right of any beneficiary to object to the decanting and bring an action opposing it.

C. Consent

Beneficiary consent to a decanting generally is not required in any state and there are both gift and generation skipping transfer tax reasons for this. The exceptions are Nevada where property specifically allocated to a beneficiary of the first trust will no longer for allocated for the beneficiary under either the first or the second trust and Ohio, where consent of the beneficiaries of the second trust or court approval is required where the second trust increases or changes the method for computing compensation of the trustee.

D. Judicial Proceedings:

Judicial approval of the trustee’s exercise of a statutory decanting power generally is not required. 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).

Some statutes, such as those in Arizona, Illinois, Kentucky, Nevada, New York and North Carolina make it clear that the trustee can petition for a court approval.

The Alaska statute specifically provides that the trustee can act without court approval.

Where a statute is silent on this point, it should be presumed that the trustee can petition the court having jurisdiction over the first trust to approve a proposed decanting.

VI. Additional Statutory Provisions.

A. The Alaska, Delaware and Nevada statutes expressly permit the instrument creating the second trust to provide that at a time or the occurrence of an event specified in the second trust, the remaining assets of the second trust must be held for the beneficiaries of the first trust on terms and conditions that are substantially identical to the terms and conditions of the first trust.

B. Several statutes contain provisions intended to protect a trustee who does not exercise a decanting power. These statutes make it clear that a trustee has no duty to decant (see Florida, Indiana, Nevada, New Hampshire, New York, North Carolina and Missouri), and some further provide that no inference of impropriety is to be made where the trustee does not exercise the power to decant (i.e., Florida, Indiana and North Carolina).

C. Virtually all of the statutes also make it clear that decanting is not prohibited if the first trust contains a spendthrift clause, or contains provisions that specifically prohibit amendment or revocation of the trust. Again, under most of the statutes, the power to decant is equivalent to the trustee’s exercise of a special power of appointment with respect to the assets of the trust, and is not deemed to be a power to amend the trust.
D. Most of the statutes also make it clear that the statute does not abridge the right of a trustee to act under an invasion power set forth in the instrument creating the first trust, under any other applicable state laws or under common law.

E. A particular state’s decanting statute will generally apply to any trust that is governed by the law of that state. However, it is not always easy to determine which state’s law applies to a trust, particularly if the trust has been subject of a change in situs or a prior decanting. It may be that a trust administered in one state still remains subject to the substantive laws of another state. In such a case, a conflicts of law analysis may be necessary to determine whether a particular decanting statute applies to the trust.

Alaska’s statute applies to all trusts governed by Alaska law, and may specifically include a trust with an Alaska resident trustee if a majority of the other trustees elect to have the primary administration of the trust located in Alaska. New York contains a similar provision with respect to the application of its statute.

F. Some state decanting statutes also include the following additional provisions:

1. The New York statute prohibits the trustee from exercising the decanting power in order to eliminate a provision in the first trust that authorizes the removal of the trustee exercising the decanting power;

2. The New York and Illinois statutes specifically permit the trustee of the first trust to extend the duration of the first trust under the second trust. For example, a trust that is supposed to terminate when the beneficiary attains age 35 can be extended to last for the life of the beneficiary under the New York and Illinois statutes. The ability to extend the duration of the first trust is also implied under the Ohio statute.

3. Under the New York and Illinois statutes, unless the trustee provides otherwise, if all of the assets comprising the principal of the first trust are appointed to a second trust, this includes all subsequently discovered assets of the first trust and all undistributed principal acquired after the appointment to the second trust. This provision does not apply if only a portion of the principal is appointed. In such a case, subsequently discovered or acquired property remains in the first trust; and

4. Under the Illinois, New York and Ohio statutes, the trustee is prohibited from decanting in order to change (i.e., increase) his commissions under the second trust. The extension of the duration of the trust, however, is not considered an increase in the trustee’s commissions, so that the trustee is permitted to continue to receive commissions during the extended term of the second trust.

VII. Conclusion.

As can be seen, although all of the state decanting statutes are intended to achieve the same result, they differ, sometimes significantly, in their scope and complexity. Thus, it is important that the trustee and any attorney advising the trustee carefully review the applicable state
statute to ensure that the proposed decanting complies with all of the statutory requirements and
does not violate any statutory restrictions on the trustee’s exercise of a decanting power.

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this material was prepared and are subject to change.
The following comments ("Comments") are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (the "Section"). Neither the House of Delegates nor the Board of Governors of the American Bar Association approved the Comments. The Comments should not be construed as representing the position of the American Bar Association.

The Comments were prepared by a working group comprised primarily of members of the Generation Skipping Transfer Tax Committee of the Income and Transfer Tax Planning Group of the Real Property, Trust and Estate Law Section of the American Bar Association. The working group was chaired by Amy E. Heller and Rana H. Salti. Significant drafting contributions also were made by William R. Culp, Anthony L. Engel, Meryl G. Finkelstein, Todd A. Flubacher, Kimberly M. Gill, Toni Ann Kruse, Briani Bennett Mellen, Thomas R. Pulsifer, J. Clare Rose, and James P. Spica. The Comments were reviewed by Carlyn S. McCaffrey on behalf of the Section’s Committee on Governmental Submissions and by David M. English and Gideon Rothschild on behalf of the Section’s Executive Committee.

Although the attorneys who participated in preparing these Comments have clients who may be affected by the legal issues addressed by the Comments, no such member (or firm or organization to which any such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.1

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1 One of the attorneys who participated in drafting the Comments also participated in the preparation New York State Bar Association Tax Section and Trusts and Estates Law Section Report on Notice 2011-101 (April 26, 2012), hereinafter referred to as the “NYSBA Report.” Portions of the text drafted by this attorney in connection with the NYSBA Report are included in these Comments.
# TABLE OF CONTENTS

1. **Overview of Trust Decanting** .................................................................................................................. 2  
   1.1 Description of Decanting ......................................................................................................................... 2  
   1.2 Common Law Authority for Decanting ...................................................................................................... 2  
   1.3 Statutory Authority for Decanting ............................................................................................................ 3  

2. **Income Tax Issues** .................................................................................................................................... 5  
   2.1 Fiduciary Income Tax Consequences ......................................................................................................... 5  
   2.2 Gain Recognition ........................................................................................................................................ 7  
      2.2.1 Gain Recognition by Beneficiaries ................................................................................................... 7  
      2.2.2 Gain Recognition by the Distributing Trust ......................................................................................... 8  
   2.3 Identity of the Grantor .............................................................................................................................. 10  

3. **Gift Tax Issues** ......................................................................................................................................... 10  
   3.1 Decanting by a Trustee who is not a Beneficiary ................................................................................... 11  
   3.2 Decanting by a Trustee who is a Beneficiary ........................................................................................... 12  
   3.3 Creation of a Power of Appointment and the Delaware Tax Trap ......................................................... 13  
   3.4 Elimination of a Power of Appointment .................................................................................................... 14  

4. **Estate Tax Issues** ...................................................................................................................................... 14  
   4.1 Identity of the Transferor ........................................................................................................................ 14  
   4.2 Estate Inclusion ......................................................................................................................................... 15  
   4.3 [Delaware Tax Trap] .................................................................................................................................. 15  

5. **Generation-Skipping Transfer (“GST”) Tax Issues** .................................................................................. 16  
   5.1 Distributing Trust Not Exempt from the GST Tax ................................................................................... 16  
   5.2 Distributing Trust is a Grandfathered Trust .............................................................................................. 17  
   5.3 Distributing Trust is Exempt by Reason of GST Exemption Allocation ................................................. 18  
   5.4 Distributing Trust has Non-U.S. Transferor ........................................................................................... 19  
   5.5 Distributing Trust and Receiving Trust Have Different Degrees of Protection from the GST Tax .......... 19  
   5.6 Identity of the Transferor ........................................................................................................................ 20
1. Overview of Trust Decanting

1.1 Description of Decanting

“Decanting” generally refers to the exercise of a discretionary fiduciary power to distribute some or all of the assets from one trust (a “Distributing Trust”) to another trust (a “Receiving Trust”). Decanting authority can be conferred by common law, statute or by the terms of a trust instrument. Decanting powers may be exercised for a variety of reasons, including to address changed circumstances, divide or combine trusts, implement administrative changes, or correct drafting errors.2

1.2 Common Law Authority for Decanting

Any discretionary power of a trustee to distribute trust assets is a special power of appointment within the meaning of many states’ powers of appointment laws and is so classified by the Restatement (Second) of Property: Donative Transfers and Restatement (Third) of Property: Wills and Other Donative Transfers (collectively, the “Restatements”).3 The Restatements both assert that this special power of appointment implies the power to decant:

Except to the extent that the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment in any form, including one in trust . . . that only benefits permissible appointees of the power. 4

Accordingly, in the view of the Restatements, unless the trust instrument that created the power specifically prohibits decanting, a trustee’s power to make discretionary distributions (as a special power of appointment) includes the power to make distributions in trust for permissible distributees.

Case law in Florida and New Jersey reinforces the Restatements’ view. In Phipps v. Palm Beach Trust Company,5 the Supreme Court of Florida held that a trustee with “sole absolute discretion” to direct distributions of trust assets for the benefit of one or more of the settlor’s descendants was permitted to direct that such distributions be made in trust. The court explained that a fiduciary power to transfer a fee simple interest in trust assets (i.e., to make outright distributions) includes the power to create any lesser estate (i.e., to make distributions in

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3 See Restatement (Second) of Prop.: Donative Transfers § 11.1 cmt. d (1986); Restatement (Third) of Prop.: Wills & Other Donative Transfers § 17.1 cmt. g (2011).


5 Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940).
trust) unless the trust instrument clearly expresses a contrary intent. In *Wiedenmeyer v. Johnson*, the Appellate Division of the New Jersey Superior Court concluded that trustees who had the “absolute and uncontrolled discretion” to distribute trust assets as they deemed to be “in the best interests” of a beneficiary (but no specific power to decant) had the ability to distribute assets to the beneficiary subject to his obligation to distribute assets to a trust for his benefit.6

### 1.3 Statutory Authority for Decanting

To date, seventeen states have enacted decanting legislation. Decanting statutes permit a trustee who has the authority to invade the principal, and in some cases the income, of an existing trust to exercise that authority by transferring some or all of the assets of the trust in further trust.

The first state decanting statute, New York Estates Powers and Trusts Law Section 10-6.6(b), became effective on July 24, 1992. Since the enactment of the New York statute, sixteen other states – Alaska,7 Delaware,8 Florida,9 Tennessee,10 South Dakota,11 New Hampshire,12 North Carolina,13 Arizona,14 Nevada,15 Indiana,16 Missouri,17 Ohio,18 Virginia,19 Kentucky,20 and, most recently, Rhode Island21 and Illinois22 – have enacted decanting statutes.

The rationale that generally underlies state decanting statutes is that a trustee who has the discretion to distribute trust property to or for the benefit of one or more beneficiaries of a trust has a special power of appointment over the trust property that allows the trustee to distribute the trust property not only outright to the beneficiaries of the Distributing Trust, but also to another trust for the benefit of one or more beneficiaries. As a result, under the majority of the state decanting statutes, the trustee’s power to appoint property to a new trust is expressly equivalent to the exercise by the trustee of a non-general power of appointment.23

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8 12 Del. C. §3528.
16 Ind. Code §30-4-3-36.
17 Mo. Uniform Trust Code §456.4-419.
23 This is specifically provided for under nearly all of the state decanting statutes except for a few, including Tennessee, New Hampshire, Missouri and Ohio.
Although the decanting statutes differ in their specific approaches, many of them contain certain common provisions, including those addressing: (i) the level of discretion that the trustee must hold with respect to the power to invade the Distributing Trust, (ii) whether a decanting power may also be based upon a discretionary power to distribute trust income, (iii) the persons for whose benefit the power to invade the Distributing Trust may be exercised and the permissible beneficiaries of the Receiving Trust, (iv) limitations on the trustee’s exercise of the power that are intended to preserve certain tax benefits of the Distributing Trust such as marital and charitable deductions and gift tax annual exclusions, (v) restrictions on the ability of a beneficiary-trustee to exercise a decanting power, and (vi) the procedural aspects of the trustee’s exercise of the decanting power, including method of exercise, notice to beneficiaries, consent and court filing requirements.

Under some decanting statutes, a trustee’s power to invade principal must be “absolute” or unlimited. The vast majority of statutes permit a decanting power to be exercised even if a standard for invasion of trust assets (such as an ascertainable standard) is set forth in the trust instrument. The Alaska and New York statutes require that an invasion standard that appears in the trust instrument of the Distributing Trust must be included in the trust instrument of the Receiving Trust, while the Arizona statute requires that the standard included in the instrument of the Receiving Trust be the same as or more restrictive than the standard provided for in the instrument of the Distributing Trust where the trustee exercising the decanting power is a possible beneficiary under the standard.

All of the decanting statutes apply to a trustee’s discretionary authority to distribute trust principal. In addition, certain state statutes, including the Nevada, North Carolina, South Dakota and Missouri statutes, expressly permit the decanting of trust income. The Arizona and New Hampshire statutes do not distinguish between income and principal as they refer only to the trustee’s power to make distributions from the Distributing Trust.

Virtually all of the decanting statutes require that the power to distribute in further trust be exercised in favor of one or more of the beneficiaries of the Distributing Trust. This generally allows the Receiving Trust to eliminate as beneficiaries one or more beneficiaries of the Distributing Trust. In addition, most of the statutes either expressly or impliedly prohibit the addition of new beneficiaries in the Receiving Trust, but certain statutes permit the interests of remainder beneficiaries of the Distributing Trust to be accelerated under the Receiving Trust. In addition, some statutes permit beneficiaries to be added by permitting the Receiving Trust to grant a current beneficiary of the Distributing Trust a limited power of appointment exercisable in favor of persons who are not beneficiaries under the Distributing Trust.

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24 See, e.g., Florida, Indiana and Ohio.
26 See, e.g., South Dakota and Missouri.
27 See, e.g., Delaware, Nevada, New York and North Carolina. Even if a decanting statute does not explicitly give a trustee the power to grant a beneficiary a power of appointment, such a power may exist under common law. See In re Hatch (Moore), 493 N.Y.S.2d 924 (N.Y. Sup. Ct. 1985), which allowed the donee of a general power of appointment that had been partially converted to a special power to create in a permissible appointee under her power a new special power of that included persons who were not objects of the original power.
Many of the statutes, particularly the more modern statutes, contain provisions intended to preserve tax benefits available to the Distributing Trust, including marital and charitable deductions and annual gift tax annual exclusions. Many (but not all) statutes also contain provisions that prevent the Receiving Trust from extending the permissible period of the rule against perpetuities applicable to the Distributing Trust.

Under all of the decanting statutes, the power to distribute in further trust must be exercised by the trustee of the Distributing Trust, not by its beneficiaries. Where the trustee is also a beneficiary of the trust, some statutes, such as those enacted in Nevada, New York, New Hampshire, North Carolina, South Dakota and Missouri, specifically restrict (or even prohibit) such beneficiary-trustee’s ability to decant.

The statutes also contain varying provisions relating to the method by which a trustee must exercise a power to distribute in further trust, whether notice of the decanting must be given to the beneficiaries of the Distributing Trust and the contents of such notice, and whether court approval of a proposed decanting is required. None of the decanting statutes require beneficiary consent, except the Nevada statute, which requires consent in the limited circumstance where property is specifically allocated for one beneficiary of the Distributing Trust and is no longer allocated for that beneficiary under either the Distributing Trust or the Receiving Trust.

2. Income Tax Issues

The exercise of a power by a trustee to distribute assets from a Distributing Trust to a Receiving Trust raises a number of income tax issues. Section 2.1 addresses issues related to the fiduciary income tax consequences of such a distribution. Section 2.2 addresses issues

28 See, e.g., FLA. STAT. § 736.04117(3) (2012). Indiana, Nevada, New Hampshire, New York and North Carolina have provisions similar to Florida’s in this respect.

29 See, e.g., NEV. REV. STAT. § 163.556(2)(c) (2011). New Hampshire, New York (with respect to annual exclusions) and Delaware, Missouri, North Carolina and South Dakota (for contributions to Code §2503(c) trusts) have provisions similar to Nevada’s in this respect.


31 See, e.g., NEV. REV. STAT. § 163.556(3) (2011). New York, New Hampshire, North Carolina, South Dakota and Missouri have provisions similar to Nevada’s in this respect.

32 The Delaware, Florida, Indiana, Nevada, New York, North Carolina, South Dakota and Tennessee statutes all set forth a specific manner of exercise while the Alaska, Arizona, Missouri and New Hampshire statutes are silent.

33 The Florida, Indiana, Missouri, New Hampshire, New York, North Carolina and South Dakota statutes all contain notice provisions.

34 The Ohio statute requires court approval for the decanting of testamentary trusts.


36 While we have limited our discussion to issues specific to decanting, similar income tax issues arise if a beneficiary exercises a non-fiduciary power to appoint assets from a Distributing Trust to a Receiving Trust.
related to potential gain recognition by the beneficiaries of the Distributing Trust or by the Distributing Trust itself. Section 2.3 addresses the identity of the grantor following the distribution.

2.1 Fiduciary Income Tax Consequences

Under the rules of Subchapter J of Chapter 1 of the Internal Revenue Code, a distribution from a complex trust generally will carry out a share of the trust’s distributable net income, or DNI, to the beneficiary to whom the distribution is made. The beneficiary, in turn, generally will be required to include in gross income an amount equal to the share of the DNI carried out from the trust. If the trust making the distribution is a foreign trust, the distribution also may carry out a share of the trust’s undistributed net income, or UNI, which will be taxed to the beneficiary as an accumulation distribution, subject to an interest charge.

There does not appear to be any authority that specifically provides that the rules of Subchapter J apply to a decanting distribution from a Distributing Trust to a Receiving Trust. However, the Treasury Regulations and case law indicate that a trust can be a beneficiary of another trust, with the rules of Subchapter J applicable to a distribution to the beneficiary trust. As a general rule, we believe that it is appropriate for the rules of Subchapter J to apply to a decanting distribution from one trust to another trust.

An exception to this general rule, however, may be appropriate when all of the assets of a Distributing Trust are distributed to a Receiving Trust having substantially similar terms. In this case, it seems appropriate to view the Receiving Trust simply as a continuation of the Distributing Trust, such that the distribution to the Receiving Trust does not carry out DNI (or UNI if the Distributing Trust is a foreign trust). This result is consistent with the conclusion reached by the Internal Revenue Service in Private Letter Ruling 200607015. If all of the assets of a Distributing Trust are distributed to one or more Receiving Trusts, there also is a question as to whether the Receiving Trust or Trusts should succeed to the Distributing Trust’s tax attributes, such as its net operating loss carryovers, its capital loss carryovers and its foreign tax credit carryovers. The Code specifically provides that on the termination of a trust, unused net operating loss carryovers and capital loss carryovers pass out to the trust’s beneficiaries. There does not appear to be specific authority addressing the transfer

37 References to the “Code” are to the Internal Revenue Code of 1986, as amended, references to “Treas. Reg.” are to the Treasury regulations promulgated under the Code.
38 Code §661.
39 Code §662.
40 Code §§665-668.
41 See Treas. Reg. § 1.643(c)-1, which provides that for purposes of Part I of Subchapter J (which includes the fiduciary income tax rules described above), a beneficiary includes an “heir, legatee or devisee (including an estate or trust)” (emphasis added). See also Duke v. Comm'r, 38 BTA 1264, 1269 (1938); Comm'r v. Bishop Trust Co., 136 F2d 390 (9th Cir. 1943), aff'd 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).
42 See also Priv. Ltr. Rul. 200723014 (June 8, 2007) and Priv. Ltr. Rul. 200527007 (July 8, 2005).
43 Code §642(h); Treas. Reg. §1.642(h)-3(d).
of other tax attributes to beneficiaries upon the termination of a trust. At a minimum, if all of the
assets of a Distributing Trust are distributed to a Receiving Trust that has substantially similar
terms and that is viewed as a continuation of the Distributing Trust, we believe that the
Receiving Trust should succeed to all of the Distributing Trust’s tax attributes.44

2.2 Gain Recognition

In a number of Private Letter Rulings, the IRS has addressed whether a distribution from
one trust to another trust causes gain to be recognized under Code §1001.45 In considering
possible gain recognition on such a distribution, there are two separate issues – first, whether
gain should be recognized by the beneficiaries of the Distributing Trust, and second, whether
gain should be recognized by the Distributing Trust itself.

2.2.1 Gain Recognition by Beneficiaries

As a general matter, gain or loss is realized under Code §1001 upon the conversion of
property into cash or upon the exchange of property for other property that differs materially in
either kind or extent.46 In Cottage Savings v. Comm’r,47 the U.S. Supreme Court adopted a
liberal test for when property received in an exchange would be considered to be materially
different from the property transferred. The Court determined that “properties are ‘different’ in
the sense that is ‘material’ to the Internal Revenue Code so long as their respective possessors
enjoy legal entitlements that are different in kind or in extent.”48

A number of Private Letter Rulings released after the Cottage Savings decision suggest
that a distribution from one trust to another might constitute a taxable exchange of an interest by
each beneficiary of a Distributing Trust for an interest in a Receiving Trust if the beneficiary’s
new interest is “materially different” from its old interest.49 In each of these rulings, the IRS
found that the beneficiary’s interests in the two trusts were not materially different and therefore
that the beneficiary did not recognize gain. We believe that even in a situation where a
beneficiary’s interests in a Distributing Trust and a Receiving Trust do differ materially, a
decision by a trustee to decant trust property should not result in gain recognition to the
beneficiary. Unlike a holder of securities in Cottage Savings, a beneficiary of a trust that is

44 Allowing a Receiving Trust to succeed to the tax attributes of a Distributing Trust, even if the terms of the trusts
are not substantially similar, would be consistent with other areas of the tax law. For example, if a private
foundation transfers all of its assets to one or more private foundations that are effectively controlled by the
same persons that control the transferor private foundation, the transferee private foundation is treated as if it
were the transferor for purposes of Chapter 42 of the Code. See Treas. Reg. §1.507-3(a)(9). Similarly, in the
case of a corporate reorganization, a successor corporation generally succeeds to the tax attributes of a
terminating corporation. See Code §381.

45 (Feb. 17, 2006). See also Priv. Ltr. Rul. 200227020 (July 7, 2002), Priv. Ltr. Rul. 9450036 (Dec. 16, 1994) and


48 Id. At 565.

49 See e.g., Priv. Ltr. Rul. 201207001 (Feb. 17, 2012); Priv. Ltr. Rul. 201136014 (Sept. 9, 2011); Priv. Ltr. Rul.
199951028 (Sept. 28, 1999).
decanted by a trustee has not exchanged any interest. Rather, the trustee has taken the action that causes the property to be distributed from the Distributing Trust to the Receiving Trust.

Other Private Letter Rulings issued by the IRS have been consistent with this view. These rulings indicate that a beneficiary will not recognize gain in the case of a distribution to another trust that is authorized by the trust instrument or by local law. These rulings also are 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 either in kind or extent if applicable state law or the governing instrument authorizes the severance and the non-pro rata funding.

The only authority of which we are aware that suggests that gain may be recognized by a beneficiary on a distribution from one trust to another is Rev. Rul. 69-486. This Revenue Ruling indicates that a distribution may result in gain recognition to a beneficiary in a narrow set of circumstances, specifically where the distribution (1) occurs as a result of an agreement by the beneficiaries and, in addition, (2) is not authorized under the terms of governing instrument or applicable state law. Accordingly, based on Rev. Rul. 69-486, even in a situation where beneficiaries act to effectuate a distribution from one trust to another or where their consent to the distribution is required as a matter of law, we believe that gain should not be recognized as long as the distribution is authorized under the terms of the governing instrument or local law. This conclusion is consistent with Cottage Savings, given that, in such a situation, the beneficiaries’ legal entitlements in the Distributing Trust include the right to have assets distributed to the Receiving Trust.

2.2.2 Gain Recognition by the Distributing Trust

There is also a question as to whether a Distributing Trust recognizes gain when appreciated trust assets are distributed to a Receiving Trust. We believe that, as a general matter, there should be no gain recognized by a Distributing Trust in such a situation.

If both the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person for income tax purposes, no gain should be recognized on the distribution based on principles of Rev. Rul. 85-13. Moreover, regardless of whether the Distributing

51 1969-2 CB 159.
52 Even in a situation where a distribution from one trust to another occurs as a result of an agreement by beneficiaries and is in contravention of the terms of a trust agreement or local law, if the beneficiaries’ interests in the Distributing Trust and the Receiving Trust are discretionary rather than fixed, it would be difficult to conclude that the beneficiaries’ legal entitlements have been modified. A discretionary beneficiary generally has no legal entitlement to trust distributions.
53 See also Treas. Reg. §1.1001-3(c)(1)(ii), which provides that an alteration of a legal right or obligation that occurs pursuant to the terms of a debt instrument generally is not a modification of the instrument that will cause recognition under Code §1001, whether the alteration occurs automatically by operation of the terms of the debt instrument or whether it occurs as a result of the exercise of an option provided to an issuer or a holder to change the terms of the instrument.
55 1985-1 CB 184.
Trust and the Receiving Trust are grantor trusts deemed owned by the same person, no gain should be recognized for the same reason that no gain is recognized when a settlor transfers property to a domestic non-grantor trust. There is no amount realized by the settlor, because the settlor is considered to receive nothing in exchange for the transfer. Nonrecognition treatment also is consistent with CCA 200923024, which concludes that the conversion of a nongrantor trust to a grantor trust is not a transfer of property that requires gain to be recognized.

There are two possible exceptions to the general result of nonrecognition on a transfer of appreciated property from one trust to another. The first such exception results from the application of Code §684. Under Code §684, if a U.S. person transfers property to a foreign nongrantor trust, the transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred, with the transferor recognizing gain. Accordingly, a distribution of appreciated assets from a Distributing Trust that is a domestic trust to a Receiving Trust that is a foreign nongrantor trust will result in gain recognition under Code §684. We note that if a transfer of property to a trust were generally to result in the recognition of gain, the special rule of Code §684 would not be necessary.

A second possible exception to nonrecognition on a transfer of appreciated property from one trust to another may apply in a situation where the property that is transferred is encumbered with debt in excess of basis or is a partnership interest with a negative capital account. In such a case, gain may result based on principles of Crane v. Commissioner. In Crane v. Commissioner, the Supreme Court held that a taxpayer’s amount realized includes recourse and nonrecourse liabilities from which the taxpayer is discharged. Based on Crane, the IRS has concluded in several instances that a termination of grantor trust status results in gain recognition if the trust holds property having liabilities in excess of basis or partnership interests with negative capital accounts.

It is not clear, however, that Crane and its progeny are applicable to a distribution from a nongrantor trust. This is because of Code §643(e), which provides that gain generally is not recognized on a distribution of appreciated property from a non-grantor trust. There does not appear to be any authority as to whether Crane overrides Code §643(e). We recommend that

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56 June 5, 2009.
57 331 U.S. 1 (1947).
58 See also Treas. Reg. §1.1001-2(a)(1), which provides that “the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.”
60 Code §643(e) is not applicable in a case where the Distributing Trust is a grantor trust. This is because Code §643(e) applies for purposes of Subparts A, B, C and D of Part I of Subchapter J. The grantor trust rules are found in Subpart E of Part I of Subchapter J. Accordingly, in the case of a distribution of property encumbered with debt in excess of basis or negative capital account partnership interests from a grantor trust to a non-grantor trust or to a grantor trust deemed owned by a different person, gain may be recognized under principles of Crane.
61 Under Code §643(e), gain is recognized on a distribution of appreciated property from a trust if an election is made to recognize gain under Code §643(e)(3) or if the distribution of appreciated property is made in satisfaction of a pecuniary amount. Code §643(e)(1) provides that “the basis of any property received by a beneficiary in a distribution from an estate or trust shall be (A) the adjusted basis of such property in the hands
any forthcoming IRS guidance address this point. However, regardless of whether Crane trumps Code §643(e), if all of the assets of a Distributing Trust are distributed to a Receiving Trust that is viewed as a continuation of the Distributing Trust (as described above in Section 2.1) or if both the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person, gain should not be recognized on the distribution.

2.3 Identity of the Grantor

If property is distributed from one trust to another trust, it is important to be able to identify the “grantor” of the Receiving Trust for income tax purposes. Among other reasons, identifying the grantor of the Receiving Trust may be necessary in order to determine whether the Receiving Trust is a grantor trust under Code §§671 through 679.

Treas. Reg. §1.671-2(e)(5) provides that if a trust makes a transfer to another trust, the grantor of the Distributing Trust generally will be treated as the grantor of the Receiving Trust. There is an exception to this general rule if property is distributed from a Distributing Trust to a Receiving Trust pursuant to the exercise of a general power of appointment. In such a case, the person exercising the power of appointment will become the grantor of the Receiving Trust. This result is consistent with Code §2514, which provides that a person who exercises a general power of appointment will be treated as making a transfer of property for gift tax purposes.

We generally agree with the positions taken in the regulations on this issue. However, we believe further refinement is needed in circumstances where a transfer from a Distributing Trust to a Receiving Trust is treated, in whole or in part, as a gift by a trust beneficiary who does not hold a general power of appointment over the Distributing Trust. An example would be a situation in which the consent of a mandatory income beneficiary of a Distributing Trust were required in order to distribute assets to a Receiving Trust. In this case, the beneficiary would be treated as making a taxable gift to the Receiving Trust equal to the value of his or her income interest in the Distributing Trust. It seems to follow that the income beneficiary of the Distributing Trust should be treated as the grantor for the portion of the Receiving Trust attributable to his or her transfer.

3. 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. The gift tax is imposed on the donor’s act of making a transfer rather than on the receipt of property by the donee. While both direct and
indirect gifts may be subject to the gift tax, in order for a gift tax to be imposed, there must be a voluntary and intentional act of transfer.\textsuperscript{64}

We believe that a decanting distribution from a Distributing Trust to a Receiving Trust should result in the imposition of a gift tax in only limited circumstances. Section 3.1 addresses the gift tax consequences of an exercise of a decanting power by a trustee who is not a beneficiary of a Distributing Trust. Section 3.2 addresses the gift tax consequences of a decanting by a trustee who also has a beneficial interest in the Distributing Trust. Section 3.3 examines the special case of a decanting that creates a power of appointment and the so-called “Delaware tax trap.” Section 3.4 addresses the elimination of a power of appointment.

### 3.1 Decanting by a Trustee who is not a Beneficiary

As a general matter, a trustee’s exercise of a discretionary power to distribute trust assets in a manner that favors one or more beneficiaries over other beneficiaries does not give rise to a taxable gift.\textsuperscript{65} If, however, the terms of applicable state law or a trust instrument require that a beneficiary consent to a decanting, and the beneficiary in fact consents in a manner that reduces his or her beneficial interest, the beneficiary may be deemed to make a transfer that is subject to the gift tax.\textsuperscript{66}

As described above in Section 1.3, we are aware of only one state statute that requires that beneficiaries consent to a decanting, and only under limited circumstances.\textsuperscript{67} A number of state statutes, however, require that notice of a decanting be given to the beneficiaries of a Distributing Trust.\textsuperscript{68} The receipt of notice of a decanting does not give beneficiaries a legal right to prevent a decanting, as long as the trustee’s exercise of the decanting power is consistent with the terms of applicable state law or the governing instrument and is not an abuse of discretion.\textsuperscript{69}


\textsuperscript{65} See Treas. Reg. § 25.2511-1(g)(1), which provides that a transfer by trustee who has no beneficial interest in property is not gift by trustee.

\textsuperscript{66} See Cerf v. Comm'r, 141 F.2d 564 (3d Cir. 1944) (holding that a beneficiary’s consent to an amendment of trust that eliminates the beneficiary’s control over the right to receive income constitutes a taxable gift). But see Estate of Franklin Lewis Hazelton, 29 T.C. 637 (1957) (holding that where, at the request of a beneficiary, a trustee of a trust transferred property to a new trust that had been created by the beneficiary in order to enlarge the beneficial interest of another person in the original trust did not result in a deemed gift by the beneficiary) and Matthew Lahti, 6 T.C. 7 (1946). See also Code §2514(b) and Treas. Reg. §25.2514-3(b).

\textsuperscript{67} See Nev. Rev. Stat. §163.556(2)(e), which requires a beneficiary to consent to a decanting if property specifically allocated to the beneficiary under the terms of the trust agreement of the Distributing Trust ceases to be allocated to the beneficiary under the terms of the trust agreement Receiving Trust. If the consent of a beneficiary were required in order to enlarge (rather than reduce or eliminate) the beneficiary’s interest, arguably the beneficiary would have a general power of appointment over all or a portion of the Distributing Trust. See Treas. Reg. §25.2514-3(b) (discussed further below in Section 3.2).

\textsuperscript{68} The statutes of Florida, Indiana, Missouri, New Hampshire, New York, North Carolina and South Dakota statutes contain beneficiary notice provisions. FLA. STAT. § 736.04117(4) (2012); S.D. CODIFIED LAWS §§ 55-2-18 (2011); N.H. REV. STAT. ANN. § 564-B: 4-418(d) (2012); N.C. GEN. STAT. § 36C-8-816.1(f)(2) (2012); IND. CODE § 30-4-3-36(e) (2012); MO. REV. STAT. § 456.4-419.3. (2011).

\textsuperscript{69} Restatement (Third) of Trusts §50.
Accordingly, a beneficiary who receives notice of a decanting does not make a voluntary transfer to other beneficiaries simply because he or she received notice of the decanting. Furthermore, even in a situation where a trustee exercises a decanting power in a manner that is not consistent with the terms of applicable law or the trust’s governing instrument or is an abuse of discretion, no gift should result by a beneficiary who does not exercise a right to object to the decanting if the beneficiary lacks the information required to know that the decanting was unauthorized or if the potential costs of preventing or reversing the decanting could reasonably exceed the benefits to the beneficiary.\(^70\)

We also believe that a decanting should not result in a taxable gift under any circumstances if the decanting results only in changes to a trust’s administrative provisions or otherwise does not modify the beneficial interests of beneficiaries who consent to the decanting.\(^71\)

Similarly, if a beneficiary whose interest is reduced in a decanting consents to the decanting at the trustee’s request or agrees to release the trustee, we believe that the beneficiary should not be deemed to make a taxable gift as long as the decanting could have been effectuated by the trustee under the terms of the trust instrument or state law without the beneficiary’s consent.

### 3.2 Decanting by a Trustee who is a Beneficiary

If a trustee who also is a beneficiary exercises a decanting power in a manner that decreases his or her beneficial interest in a trust, he or she may make a taxable gift to other beneficiaries.\(^72\)

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\(^70\) See I.R.S. Gen. Couns. Mem. 38584 (Dec. 10, 1980) (recognizing that under certain circumstances, permitting the statute of limitations to expire on a previously enforceable debt may not result in a gift if the lapse of the limitations period was allowed in the ordinary course of business, as described by Treas. Reg. § 25.2512-8); See also Treas. Reg. § 25.2512-8 ("[A] sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm’s length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money’s worth). But see Rev. Rul. 86-39, 1986-1 CB 300 (where a surviving spouse had an enforceable right to require that a marital trust be adequately funded, the spouse’s failure to enforce such right under local law resulted in a taxable gift by the spouse of the underfunded amount).

\(^71\) See e.g., Priv. Ltr. Rul. 9826050 (June 26, 1998) (modification of trust that is administrative in nature and does not result in any change in the quality, value or timing of any of the powers, beneficial interests, rights or expectancies provided in the original trust does not result in a taxable gift by beneficiaries).

\(^72\) See Treas. Reg. §25.2511-1(g)(2), Code §2514(b) and Treas. Reg. §25.2514-3(b). See also Estate of Regester, 83 T.C. 1 (1984) (holding that the exercise of a special power of appointment over trust corpus by the life income beneficiary resulted in a taxable gift equal to the value of the income beneficiary’s life income interest); Rev. Rul. 79-327, 1979-2 C.B. 342 (finding that the exercise of a special power to appoint trust corpus by the life income interest resulted in a taxable gift because the exercise of the power relinquished the right to income as to the that portion of the trust corpus); and Priv. Ltr. Rul. 8824025 (June 17, 1988) (ruling that consent of co-trustee that is sole income beneficiary of trust to distribution of principal to remainder beneficiaries would result in a taxable gift). But see Self v. U.S., 142 F. Supp. 939 (Ct. Cl. 1956) (finding no taxable gift by an income beneficiary of a trust when the income beneficiary exercised a power to appoint trust corpus to his two children, resulting in a reduction of the income beneficiary’s life income interest). The Self decision was rejected by the Tax Court in Regester. See also Estate of Franklin Lewis Hazelton and Matthew Lahti, discussed above in footnote 62.
However, there are likely to be few instances in which the exercise of a decanting power by a trustee-beneficiary will result in a taxable gift. A number of state statutes preclude trust beneficiaries from participating in decanting distributions altogether. Other state statutes allow a trustee who is a beneficiary to participate in a decanting distribution but only in limited circumstances that will not result in the application of a gift tax. For example, some state statutes allow a trustee-beneficiary to whom distributions can be made based only on an ascertainable standard to participate in a decanting distribution only if the Receiving Trust limits distributions to the same standard.

Even in a case where applicable state law or the terms of a trust instrument do not limit the ability of a trustee-beneficiary to participate in the exercise of a decanting power, if the interest of the trustee-beneficiary in the Distributing Trust is discretionary, the decanting may not result in a taxable gift by the trustee-beneficiary. This is because the trustee-beneficiary has no enforceable right to distributions from the Distributing Trust. And, even if the decanting does result in a taxable gift in such a case, the gift is likely to have little value, if any.

Furthermore, a decanting by a trustee-beneficiary should not result in a taxable gift if the decanting results only in changes to a trust’s administrative provisions or otherwise does not modify the beneficial interests of beneficiaries.

3.3 Creation of a Power of Appointment and the Delaware Tax Trap

As described above in Section 1.3, a number of state decanting statutes specifically permit the trustee of a Distributing Trust to give a beneficiary of the Distributing Trust a power to appoint the trust fund of the Receiving Trust. A trustee’s grant of a power to of appointment to a beneficiary should not have gift tax consequences. As described above in Section 3.1, a trustee’s exercise of a discretionary power to distribute trust assets to a beneficiary does not give rise to a taxable gift. If a trustee can distribute trust assets to a beneficiary without causing a taxable gift, then the trustee should be able to grant a lesser interest in the property, such as a power of appointment, to the same beneficiary without giving rise to a taxable gift. A later exercise of the power of appointment by the beneficiary would have to be evaluated separately to determine whether it constituted a taxable gift by the beneficiary.

Under Code §2514(d), if a holder of a limited power of appointment exercises the power during his or her lifetime, and by such exercise creates a further power of appointment that can be exercised in a manner that may postpone the vesting of an interest in the property that was subject to the first power for a period ascertainable without regard to the date of the creation of

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73 See e.g., N.Y. EPTL §10-6.6(s)(2), N.C. Gen. Stat. § 36C-8-816.1(d).
74 See e.g., NRS 163.556-3(a)(2). and N.H. RSA §564-B:4-418. See also Treas. Reg. § 25.2511-1(g)(2) (providing that if a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it s made pursuant to the exercise of a power the exercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument).
75 See e.g., Priv. Ltr. Rul. 8535020 (May 30, 1985).
76 See e.g., Priv. Ltr. Rul. 9826050, discussed at footnote 71.
77 See Treas. Reg. § 25.2511-1(g)(1).
78 See discussion at footnote 72.
the first power, a gift tax will apply upon the exercise of the first power. This is sometimes referred to as the “Delaware tax trap.”

Most state decanting statutes have been drafted to avoid triggering the Delaware tax trap upon a trustee’s exercise of a decanting power. State statutes generally preclude a trustee from exercising a decanting power in a manner that could postpone the vesting of interests in property beyond the time by which vesting would have been required by the trust instrument of the Distributing Trust. However, under certain circumstances, it is possible that the exercise of a decanting power by a trustee could create a second power of appointment exercisable in a manner that could extend the time for vesting of a beneficial interest. For example, the Delaware tax trap has the potential to apply anytime a trustee exercises a decanting power over a Distributing Trust that is not subject to a traditional perpetuities period if the Receiving Trust is not subject to a traditional perpetuities period and confers a power of appointment on a beneficiary.

However, even in such a case, we believe that no taxable gift should result to the trustee. First, the legislative history to Code §2514(d) indicates that the Delaware tax trap was not intended to apply to fiduciary powers of appointment. Furthermore, if the trustee who exercises the power of appointment has no beneficial interest in the trust, it would be consistent with principles of Treas. Reg. §25.2511-1(g)(1) (discussed above) for there to be no gift tax consequences to the trustee.

3.4 Elimination of a Power of Appointment

A beneficiary’s loss of a presently exercisable withdrawal right or general power of appointment as a result of a decanting may result in a taxable gift by the beneficiary to the extent the value of the assets affected by the loss exceeds the greater of $5,000 or 5% of the aggregate value of assets from which the power could have been exercised (the “5 and 5 Amount”). This is because a decanting distribution by a trustee that extinguishes a beneficiary’s general power of appointment in excess of the 5 and 5 Amount may be considered to be a lapse of such power under Code §2514(e) and, as such, may be taxable to the beneficiary under Code §2514(b).

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79 See e.g., Alaska Stat. § 13.36.157(a)(3) (2008); Del. Code Ann. Tit. 12, § 3528(c) (2012), Del. Code Ann. Tit. 25, § 504 (2012); Fla. Stat. § 736.04117(3) (West Supp. 2008); N.Y. EPTL §10-6-6(p); N.C. Gen. Stat. §§ 36C-8-816.1(c)(8), (d), and 41-23(e) (2011); S.D. Codified Law §§ 43-5-5 and 55-2-20 (2012). See also Estate of Murphy v. Comr., 71 T.C. 671 (1979) (creation of new special power of appointment did not violate Delaware tax trap because Wisconsin law requires that the permissible perpetuities period be measured from the date the first power is created).

80 See S. REP. No. 82-382, at 1 (1951), as reprinted in 1951 U.S.C.C.A.N. 1535, 1535.

81 For a further discussion of this point, see William R. Culp and Briani Bennett Mellen, Use of Trust Decanting to Extend the Term of Irrevocable Trusts, 37 EST PLN 3 (2010).

82 If a beneficiary’s general power of appointment is limited by an ascertainable standard, a decanting distribution that eliminates or reduces the power in excess of the 5 and 5 Amount should not result in a taxable gift by the beneficiary. See Treas. Reg. § 25.2514-3(e), Ex. 2. Similarly, a decanting distribution that eliminates a beneficiary’s special power of appointment generally should not result in a taxable gift. Under Code §2514(b), the release or lapse of a general power of appointment, but not a special power of appointment, is treated as a transfer for gift tax purposes.
Most, if not all, state decanting statutes limit a trustee’s ability to exercise a decanting power in a manner that would extinguish a beneficiary’s general power of appointment. State decanting statutes generally either preclude a trustee from exercising a decanting power over property of a Distributing Trust that is subject to a beneficiary’s presently exercisable withdrawal right or permit such a decanting power to be exercised only to the extent that the beneficiary has a similar withdrawal right over property of the Receiving Trust.83

4. **Estate Tax Issues**

A trustee’s exercise of a power to distribute assets from a Distributing Trust to a Receiving Trust may under certain circumstances have federal estate tax consequences. Section 4.1 addresses the identity of the transferor for estate tax purposes following a decanting. Section 4.2 discusses the situations in which a decanting may cause the trust fund of a Receiving Trust to be includible in the estate of the transferor.

4.1 **Identity of the Transferor**

If property is distributed from one trust to another trust, we believe that the person who is considered to have transferred property to the Distributing Trust for federal estate tax purposes generally should be considered to be the transferor of property to the Receiving Trust for federal estate tax purposes. This should be the case regardless of whether such person is considered to be the creator of the Receiving Trust under state law.84 We also believe that an exception to this general rule should apply if a decanting results in a taxable gift. In such a case, the beneficiary who is deemed to have made the gift should be considered the transferor of property to the Receiving Trust for federal estate tax purposes to the extent of the transfer.85

4.2 **Estate Inclusion**

If, prior to a decanting, the property of a Distributing Trust was includible in the estate of the transferor due to certain retained powers or interests, and the powers or interests that caused estate inclusion are present in the governing instrument of the Receiving Trust, property of the Receiving Trust also will be includible in the transferor’s gross estate. Similarly, if, prior to a decanting, property of a Distributing Trust was not includible in the estate of the transferor and the governing instrument of the Receiving Trust confers no additional powers or interests on the transferor, the property of the Receiving Trust also should be not be includible in his or her gross estate.

There are, however, certain situations where property of a Receiving Trust may be includible in the transferor’s gross estate even though the assets of a Distributing Trust were not includible in the transferor’s estate. For example, if the transferor did not have any dispositive powers over the Distributing Trust but is given a dispositive power over the Receiving Trust, the

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83 See e.g., NRS 163.556-2(d); N.C. 36C-8-816.1(c)(6); Del. Code §3528(a)(4); S.D. Cod. Law §55-2-15(7).

84 Under decanting statutes, the trustee generally is viewed as the creator of the Receiving Trust for state law purposes. See e.g., DEL. CODE ANN. tit. 12, § 3528(c).

85 This approach is similar to the approach discussed above in Section 2.3 for determining the identity of the grantor for income tax purposes and the approach discussed below in Section 5.6 for determining the identity of the transferor for generation-skipping transfer tax purposes.
trust fund of the Receiving Trust may be includible in the transferor’s estate under Code §2038.86 Similarly, if the assets distributed to the Receiving Trust include a life insurance policy on the transferor’s life, and the trust instrument of the Receiving Trust gives the transferor a power that is an incident of ownership with respect to the policy, the value of the policy may be includible in the transferor’s estate under Code §2042(2).

5. Generation-Skipping Transfer (“GST”) Tax Issues

The GST tax consequences of a decanting distribution from a Distributing Trust to a Receiving Trust turn on the GST tax status of the Distributing Trust. Section 5.1 addresses a Distributing Trust that is not exempt from the GST tax. Section 5.2 addresses a Distributing Trust that is exempt from the GST tax because it became irrevocable prior to certain dates set forth in the Tax Reform Act of 1986, the legislation that adopted the GST tax in its present form (a “Grandfathered Trust”).87 Section 5.3 addresses a Distributing Trust that is exempt from the GST tax by reason of the allocation of the transferor’s GST exemption to the trust. Section 5.4 addresses a Distributing Trust that is not within the scope of the GST tax because its transferor was a non-domiciliary of the United States who funded the trust in a manner that was not subject to the United States gift or estate tax. Section 5.5 addresses a Distributing Trust and a Receiving Trust that are subject to or protected from the GST tax in different proportions. Finally, Section 5.6 addresses the identity of the transferor a trust for GST tax purposes following a decanting distribution. In each of Sections 5.1 through 5.4, we assume that the decanting distribution does not result in the imposition of an estate or gift tax on a person other than the transferor. To the extent estate or gift tax is imposed on another person, any exemption from the GST tax that applied to the Distributing Trust would not carry over to the Receiving Trust.

86 As a general matter, many powers that cause inclusion under Code §2038 also cause inclusion under Code §2036. However, if a power or interest described in Code § 2036 is first granted to the transferor under the trust instrument of the Receiving Trust, the assets of the Receiving Trust generally should not be includible in the transferor’s gross estate under Code §2036. This is because Code §2036 generally is applicable only in the case of powers or interests retained by the transferor from the time of his or her initial transfer to a trust. If at the time of the transferor’s initial transfer of property to a Distributing Trust, the transferor and the trustee had an agreement or understanding that the trustee would later exercise its decanting power to create a Receiving Trust under which the grantor would hold a power or interest described in Code § 2036, the property of the Receiving Trust could be includible in the estate of the grantor. See Treas. Reg. § 20.2036-1(c)(1)(i) (“An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred.”). For a discussion of whether estate inclusion under Code §2036 or §2038 may result when a grantor is involved in a decanting, please see page 29 of the NYSBA Report.

87 Section 1433(b)(2)(A) of the Tax Reform Act of 1986 provides that the GST tax does not apply to any transfer from a trust that was irrevocable on September 25, 1985 (the day before the House Ways and Means Committee began considering the bill containing the GST tax provisions). Section 1433(b)(2)(B) of the Tax Reform Act of 1986 provides that the GST tax does not apply to any transfer under a Will or revocable trust that was executed before October 22, 1986 (the date that Congress enacted the Tax Reform Act of 1986), if the decedent died before January 1, 1987. The regulations generally confirm as exempt from GST tax any GST under a trust that was irrevocable on September 25, 1985 to the extent assets are not added to the trust after that date. Treas. Reg. §26.2601-1(b)(1)(i).
5.1 Distributing Trust Not Exempt from the GST Tax

If a Distributing Trust is not exempt from the GST tax, a decanting distribution from the trust generally will trigger a GST tax if the distribution is one of three types of generation-skipping transfers identified in the Code: a direct skip, a taxable termination or a taxable distribution.88 If a decanting distribution is not one of these types of generation-skipping transfers, the distribution will not trigger a GST tax.

Whether a distribution is a generation-skipping transfer generally will turn on the identity of the transferor and the beneficiaries of the Distributing Trust and the identity of beneficiaries of the Receiving Trust. For GST tax purposes, the transferor generally is the person with respect to whom property most recently was subject to federal estate or gift tax.89 If all of the present interests in a Receiving Trust are held by persons two or more generations below the transferor (e.g., the transferor’s grandchildren or more remote descendants), the Receiving Trust will be classified as a “skip person.”90 In such a case, a distribution from the Distributing Trust to the Receiving Trust will be a direct skip if the distribution triggers a gift tax or an estate tax.91 However, as described above in Sections 3 and 4, the circumstances in which a decanting distribution will trigger a gift tax or an estate tax are limited. In a more typical situation in which a decanting distribution is not subject to gift or estate tax, the distribution generally will result in a taxable termination if the entire trust fund is distributed to a Receiving Trust and a taxable distribution if only a portion of the trust fund is distributed to the Receiving Trust.92

5.2 Distributing Trust is a Grandfathered Trust

If the trustee of a Grandfathered Trust decants trust property to a Receiving Trust, the key GST tax question is whether the decanting will cause a loss of GST exempt status. The Treasury Regulations provide two safe harbor rules for when a trustee’s distribution of property from a Grandfathered Trust to a Receiving Trust will not cause a loss of GST exempt status.

The first safe harbor provides that a distribution from a Distributing Trust that is a Grandfathered Trust to a Receiving Trust will cause neither the Distributing Trust nor the Receiving Trust to be subject to the GST tax if (1) at the time the Distributing Trust became irrevocable, the governing instrument or applicable state law authorized distributions from the Distributing Trust to other trusts without the consent or approval of any beneficiary or court and (2) the governing instrument of the Receiving Trust does not extend the time for the vesting of any beneficial interest beyond the longer of (a) 21 years after the death of any life in being at the time the Distributing Trust became irrevocable and (b) 90 years after the creation of the Distributing Trust (referred to as the “Regulatory RAP”).93 As discussed above in Section 1.3,

88 Code §2611.
89 Code §2652(a); Treas. Reg. §26.2611-1.
90 Code §2613(a)(2). A Receiving Trust also will be a skip person if (1) no person holds an interest (as defined in Code §2652(c)) in the trust and (2) distributions can never be made from the trust to an individual whose generation assignment is fewer than two generations below the transferor’s generation assignment. Id.
91 Code §2612(c).
92 See Code §2612(a), regarding a taxable termination, and §2612(b), regarding a taxable distribution.
the first decanting statute was enacted in 1992, seven years after the date by which a trust generally needs to have been irrevocable in order to be a Grandfathered Trust. Accordingly, it is not possible to satisfy the first safe harbor on the basis of any state decanting statute. In some cases, it may be satisfied by the terms of the governing instrument or by the common law of the applicable state.

The second safe harbor provides that a distribution of property from a Distributing Trust that is a Grandfathered Trust to a Receiving Trust will not cause the Distributing Trust to be subject to the GST tax if (1) the distribution does not cause a beneficial interest to be shifted to a beneficiary in a lower generation and (2) the governing instrument of the Receiving Trust does not extend the time for the vesting of any beneficial interest beyond the period provided for in the original trust instrument. We note that the Regulations do not provide a definition of the term “vesting.” The meaning of the term differs from state to state and, within a given state, may be interpreted differently by a court depending on the purpose for which the interpretation is sought.

5.3 Distributing Trust is Exempt by Reason of GST Exemption Allocation

If a Distributing Trust is exempt from the GST tax because of an allocation of GST exemption, the GST tax consequences of a decanting distribution are less clear than if the Distributing Trust is a Grandfathered Trust. Concern as to this issue is based on the hundreds of private letter rulings which predated the issuance of the safe harbor regulations described in the

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94 As discussed above in Section 1.2, a decanting power arguably existed on September 25, 1985 under the common law of some states.

95 See Treas. Reg. §26.2601-1(b)(4)(i)(D). The Treasury Regulations make it clear that if the requirements of the first safe harbor are satisfied, there will be no GST tax consequences to either the Distributing Trust or the Receiving Trust. If the requirements of the second safe harbor are satisfied, the Treasury Regulations provide that there will be no GST tax consequences to the Distributing Trust but say nothing about consequences to the Receiving Trust. This presumably is because the first safe harbor specifically addresses distributions between trusts, while the second safe harbor addresses the GST tax consequences of a variety of modifications of a Grandfathered Trust (with a distribution from such a trust being just one of these modifications). A number of Private Letter Rulings confirm that if the requirements of the second safe harbor are satisfied, property that is distributed to a Receiving Trust will retain its GST exempt status. See e.g., Priv. Ltr. Rul. 200227020 (April 1, 2002), Priv. Ltr. Rul. 9804046 (Jan. 23, 1998), Priv. Ltr. Rul. 9737024 (June 17, 1997).

96 See Example 4 of Treas. Reg. §26.2601-1(b)(4)(i)(E), which provides that changing the situs of a trust from a jurisdiction with a rule against perpetuities to a jurisdiction with no rule against perpetuities does not extend the time for vesting of any beneficial interest in a trust if the trust will terminate at the same time both before and after the change in situs, pursuant to the terms of the trust instrument. The Regulation also provides that if as a result of the change in situs, the time for vesting of a beneficial interest in the trust is extended beyond the period prescribed by the terms of the original trust instrument, the trust will lose its GST exempt status. The Regulations however, do not define or describe what is meant by the term “vesting.” See also Carol A. Harrington, Lloyd Leva Plaine, Howard M. Zaritsky, and Julie K. Kwon, Generation-Skipping Transfer Tax, 2nd edition (Warren Gorham & Lamont 2001, with 2012 cumulative supplement), Priv. Ltr Rul. 200643039 (Oct. 28, 2005), Priv. Ltr. Rul. 200607015 (Feb. 17, 2006), 200839025 (Sept. 26, 2008), Priv. Ltr. Rul. 200841027 (Oct. 10, 2008).

97 See Carol A. Harrington, Lloyd Leva Plaine, Howard M. Zaritsky and Julie K. Kwon, Generation-Skipping Transfer Tax, 2nd edition (Warren Gorham & Lamont 2001, with 2012 cumulative supplement) ¶ 7.06[2][f][ii], explaining that “a court may be more likely to construe an interest as vested to avoid a violation of the rule against perpetuities than might be the case if vesting will allow a creditor to seize that interest.”
In these rulings, the IRS took the position that a modification of a trust that was protected from GST tax by the grandfather rules that did not “change the quality, value or timing of any powers, beneficial interests, rights or expectancies” originally provided for under the terms of the trust would not result in the loss of protected status. The negative implication is that if such a change occurred, loss of protected status would result. The rationale seemed to be that the trust would no longer be the same trust. It is possible that the IRS could take the same position with respect to trusts protected by the GST exemption because the safe harbor rules described above in Section 5.2 do not apply to trusts to which GST exemption has been allocated.

In a number of Private Letter Rulings, however, the IRS has extended the safe harbor rules to trusts to which GST exemption has been allocated. In many of these rulings, the IRS has acknowledged the lack of guidance applicable to such trusts and has suggested that it may be possible to decant a trust to which GST exemption has been allocated without disrupting its GST exempt status in situations broader than those covered by the safe harbor rules:

No guidance has been issued concerning the GST tax consequences of the modification of a trust created after September 25, 1985. At a minimum, it seems appropriate to conclude that a change that would not affect the exempt status of a trust that was irrevocable on September 25, 1985 would similarly not affect the exempt status of such a trust.

With the exception discussed in the next paragraph, we recommend that guidance confirm that the safe harbor regulations apply to property which is protected from the GST tax by the allocation of GST exemption that is decanted into a Receiving Trust.

We believe that the provision of the safe harbor rules that requires the Regulatory RAP to be satisfied in order for GST exempt status to be preserved when a Grandfathered Trust is decanted should not be applicable in the case of a Distributing Trust that is exempt from the GST tax by reason of an allocation of GST exemption. When Congress enacted the GST tax in its present form, the common law rule against perpetuities was in effect in almost all states. Since this time, many states have lengthened their statutory perpetuities periods or have abolished them altogether. Accordingly, there now exist many trusts that are exempt from the GST tax by reason of an allocation of GST exemption that have perpetuities periods in excess of the Regulatory RAP. Under the current GST tax rules, a trust that has acquired GST exempt status by reason of GST exemption allocation may retain this protection beyond the Regulatory RAP. Unless this rule is changed, we believe that it should be possible to decant such trusts without a

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98 See e.g., Priv. Ltr. Rul. 9424026 (March 16, 1994).
99 See id.
loss of GST exempt status as long as any perpetuities period applicable to a Distributing Trust is maintained for the Receiving Trust. 102

5.4 Distributing Trust has Non-U.S. Transferor

Special GST tax rules apply if the transferor of property to a trust is neither a U.S. citizen nor a U.S domiciliary. As a general matter, a trust created by a non-U.S. transferor is within the scope of Chapter 13 only if the initial transfer of property to the trust was subject to federal estate or gift tax.103 We believe that a decanting distribution from a Distributing Trust that is not within the scope of Chapter 13 because of the non-domiciliary status of its transferor should be subject to the GST tax or should cause the Receiving Trust to be within the scope of Chapter 13 only if the distribution itself results in the application of a federal estate or gift tax.

5.5 Distributing Trust and Receiving Trust Have Different Degrees of Protection from the GST Tax

Suppose, for example, that a Distributing Trust and a Receiving Trust have the same transferor. The Distributing Trust has an inclusion ratio of zero and the Receiving Trust has an inclusion ratio of 1. The Receiving Trust is not a skip person. As a result, the decanting does not trigger the imposition of a GST tax. The regulations provide a method for calculating the new inclusion ratio of the Receiving Trust to adjust for the inclusion ratio of the Decanting Trust.104

We recommend that guidance confirm that the same approach should be used to adjust the portion of a Receiving Trust that will be protected from future GST taxes by reason of the Decanting Trust’s status under the grandfather rule or the non-domiciliary status of its transferor. We also recommend that guidance confirm that the transferor will be able to allocate any or all of his or her remaining GST exemption to the Receiving Trust.

5.6 Identity of the Transferor

As described above in Section 5.1, for GST tax purposes, the “transferor” of property to a trust generally is the person with respect to whom the property most recently was subject to a

102 In proposed regulations issued in 1996, the IRS sought to apply the Regulatory RAP to situations involving trusts other than Grandfathered Trusts. Prop. Treas. Reg. §26.2652-1(a)(4) provided that the “transferor” of a trust generally would shift if a power of appointment was exercised in a manner that extended perpetuities period beyond the Regulatory RAP. The provision relating to the Regulatory RAP was not included in the final regulation. See T.D. 8720, 1997-1 C.B. 187. As a result, the Regulatory RAP appears only in Treasury Regulations addressing Grandfathered Trusts. Recent proposals would limit the length of an allocation of GST exemption to a period of 90 years from the creation of the trust. See DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS 81-82 (2012). See also DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2012 REVENUE PROPOSALS 129-30 (2011) (same proposal).

103 Code §2663(2); Treas. Reg. §26.2663-2(b)(2). A transfer to a trust by a non-U.S. transferor generally will be subject to federal estate or gift tax only if the property transferred is situated within the United States. See Code §2104 (addressing when property is situated in the United States for federal estate tax purposes) and Code §2511 (addressing when property is situated in the United States for federal gift tax purposes).

federal estate or gift tax. We recommend that guidance confirm that the transferor with respect to a Distributing Trust also is the transferor with respect to the Receiving Trust except to the extent a decanting results in the imposition of a gift or an estate tax on another person. If the decanting triggers a gift or an estate tax, the person with respect to whom there has been a taxable gift or an estate inclusion should become the transferor, consistent with Code §2652(a).

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We appreciate your consideration of our comments in response to Notice 2011-101 and would be pleased to answer any questions about our comments.
Part III - Administrative, Procedural, and Miscellaneous

Transfers by a Trustee from an Irrevocable Trust to another Irrevocable Trust (sometimes called "decanting"); Requests for Comments

Notice 2011-101

PURPOSE

This notice requests comments regarding when (and under what circumstances) transfers by a trustee of all or a portion of the principal of an irrevocable trust (Distributing Trust) to another irrevocable trust (Receiving Trust), sometimes called "decanting," that result in a change in the beneficial interests in the trust are not subject to income, gift, estate, and/or generation-skipping transfer (GST) taxes. In these transfers, the interests of one or more of the beneficiaries may be changed and, in some cases, the interest of a beneficiary may be terminated and/or another beneficiary who did not have an interest in Distributing Trust may receive an interest in Receiving Trust.

BACKGROUND

The Treasury Department and the Internal Revenue Service (IRS) are studying the tax implications of such transfers when there is a change in the beneficial interests
in the trust and are considering approaches to addressing some or all of the relevant tax issues in published guidance. While these issues are under study, the IRS will not issue private letter rulings (PLRs) with respect to such transfers that result in a change in beneficial interests. See Sections 5.09, 5.16, and 5.17 of Rev. Proc. 2011-3, 2011-1 I.R.B. 111. The IRS generally will continue to issue PLRs with respect to such transfers that do not result in a change to any beneficial interests and do not result in a change in the applicable rule against perpetuities period.

REQUEST FOR COMMENTS

The Treasury Department and the IRS invite comments from the public regarding the income, gift, estate and GST tax issues and consequences arising from transfers by a trustee of all or a portion of the principal of a Distributing Trust to a Receiving Trust that change beneficial interests. The Treasury Department and IRS also invite comments as to the relevance and effect of the various facts and circumstances listed below and the identification of other factors that may affect the tax consequences. The facts and circumstances that the Treasury Department and the IRS have identified as potentially affecting one or more tax consequences include the following:

1. A beneficiary’s right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary);

2. Trust principal and/or income may be used to benefit new (additional) beneficiaries;

3. A beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;
4. The transfer takes place from a trust treated as partially or wholly owned by a person under §§ 671 through 678 of the Internal Revenue Code (a “grantor trust”) to one which is not a grantor trust, or vice versa;

5. The situs or governing law of the Receiving Trust differs from that of the Distributing Trust, resulting in a termination date of the Receiving Trust that is subsequent to the termination date of the Distributing Trust;

6. A court order and/or approval of the state Attorney General is required for the transfer by the terms of the Distributing Trust and/or applicable law;

7. The beneficiaries are required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;

8. The beneficiaries are not required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;

9. Consent of the beneficiaries and/or a court order (or approval of the state Attorney General) is not required but is obtained;

10. The effect of state law or the silence of state law on any of the above scenarios;

11. A change in the identity of a donor or transferor for gift and/or GST tax purposes;

12. The Distributing Trust is exempt from GST tax under § 26.2601-1, has an inclusion ratio of zero under § 2632, or is exempt from GST under § 2663; and

13. None of the changes described above are made, but a future power to make any such changes is created.
The Treasury Department and the IRS encourage the public to suggest a definition for the type of transfer (“decanting”) this guidance is intended to address. Additionally, the public is encouraged to comment on the tax consequences of such transfers in the context of domestic trusts, the domestication of foreign trusts, transfers to foreign trusts, and on any other relevant facts or combination of facts not included in the above list.

Written comments are encouraged to be submitted by April 25, 2012. All comments will be available for public inspection and copying and should include a reference to this Notice 2011-101. Comments may be submitted in one of three ways:

1. By mail to CC:PA:LPD:PR (Notice 2011-101), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.
2. Electronically to Notice.Comments@irsconsel.treas.gov. Please include “Notice 2011-101” in the subject line of any electronic communications.
3. By hand-delivery Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2011-101), Courier’s Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC 20224.

DRAFTING INFORMATION

The principal author of this notice is Juli Ro Kim of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, contact Juli Ro Kim at (202) 622-3090 (not a toll-free call).
April 2, 2012

Internal Revenue Service
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Via Electronic Mail:
Notice.Comments@irscounsel.treas.gov

Re: Comments of The American College of Trust and Estate Counsel on Transfers by a Trustee from an Irrevocable Trust to Another Irrevocable Trust (Sometimes called “Decanting”)(Notice 2011-101) Released December 21, 2011

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the “College”) is pleased to submit these comments pursuant to Notice 2011-101, 2011-52 I.R.B. 932, released on December 21, 2011, which requested comments regarding when (and under what circumstances) transfers by a trustee of all or a part of the principal of an irrevocable trust (“Distributing Trust”) to another irrevocable trust (“Receiving Trust”), sometimes called “decanting,” that result in a change in the beneficial interests in the trust are not subject to income, gift, estate, or generation-skipping transfer (“GST”) taxes. The initial draft of these comments was prepared prior to the issuance of Notice 2011-101. We believe that our comments respond to substantially all the issues raised by the Notice, but in the interest of completeness the format of the initial draft has been retained.

The College is also pleased to submit a proposed Revenue Ruling which would provide a series of safe harbors in the situation where a trustee with absolute discretion to distribute the corpus of a trust to its beneficiaries is granted the authority under state law to exercise that authority to transfer the corpus of the Distributing Trust to a Receiving Trust for the benefit of one or more of the beneficiaries of the Distributing Trust. The College believes that the proposed Revenue Ruling would cover the most common uses of such decanting authority and would provide helpful and much needed guidance to taxpayers.

The College is a professional organization of approximately 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of the College have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and GST tax planning, fiduciary income tax planning, and compliance. The College offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.
Introduction

Distributions of assets from one trust to another trust can occur as a result of the exercise by trustees of a statutory power, a power under the common law, or a power in the governing instrument to make such distributions or as the result of the exercise by the holder of a power of appointment to make such distributions (each, a “decanting power”). For purposes of this letter, we generally define decanting to mean the discretionary authority to distribute some or all the assets of a Distributing Trust to a Receiving Trust pursuant to a power of appointment, authority in the governing instrument, or authority under applicable state law without the need for prior court approval or the prior consent of any beneficiary of the trust. Notice 2011-101 requests comments on decanting in other contexts, such as in the context of discretionary or mandatory beneficiary consent or court approval. We offer such commentary but point out that beneficiary consent or court approval is not typically sought or required under the state decanting statutes currently in effect. Decanting does not include any required interim or final distribution from a trust by the terms of its governing instrument. We assume, unless stated to the contrary, that decanting authority exercisable by a trustee is subject to fiduciary duties, which are discussed more fully herein. We assume that decanting authority exercisable by a power of appointment not held in a fiduciary capacity is not subject to fiduciary duties. We further assume, unless stated to the contrary, that the person with decanting authority has no beneficial interest in either the Distributing Trust or the Receiving Trust as a result of the decanting. Accordingly, we assume that the decanting power itself is not a general power of appointment. We believe, however, that the tax consequences of decanting cannot conveniently be limited by a definition, but should be limited by the specific factual contexts in which decanting is employed, as in the accompanying proposed Revenue Ruling.

Decanting powers have become increasingly popular over the past twenty years as state legislatures as well as estate planning counsel have turned to such powers as a means of ensuring, particularly for long-term trusts, a method of dealing with changes in circumstances not anticipated by the drafters of original trust instruments. For example, thirteen states have adopted decanting statutes that permit trustees who have distribution powers under the Distributing Trust exercisable in favor of beneficiaries to distribute trust property to a Receiving Trust for the benefit of one or more such beneficiaries that has terms that differ from the terms of the Distributing Trust.¹ A common theme running through the professional literature discussing long term trusts is the need to provide for flexibility through the use of decanting provisions in trust instruments.²

The existence of decanting powers and their exercise present a number of complex income and transfer tax issues. The frequency with which these powers are being conferred on trustees and power holders and the frequency with which they are being exercised makes the resolution of these issues significant. This letter discusses these issues and provides analysis to assist in determining the most appropriate resolution.

Background

The first recognition by an American court of a trustee decanting power appeared in *Phipps v. Palm Beach Trust Co.* In that case, the Supreme Court of Florida (the highest court of the state) held that a trustee could invade trust property by paying it over to another trust for the beneficiary of the original trust. That decision was based on the Florida Supreme Court’s interpretation of the common law, rather than on any specific statutory authority or decanting authority in the trust instrument.

In *Phipps*, the court concluded that a trustee’s discretionary distribution authority is comparable to a special power of appointment in favor of the beneficiaries of the trust. The Florida court cited the Restatement of Trusts, section 17, for the proposition that if a trustee has a special power of appointment, that is, a power to appoint among the members of a specified class, then whether the trustee can effectively appoint a trustee for members of the class depends on the terms of the power vested in him. The court concluded that:

> The general rule gleaned from the foregoing and other cases of similar import is that the power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent.

If the reasoning in *Phipps* is sound, there is reason to believe that the common law of every other jurisdiction throughout the United States confers a decanting power on all trustees who have the power to invade trusts for the benefit of their beneficiaries. No court has held to the contrary.

Nevertheless, because of the importance of the decanting power and a reluctance among estate planning counsel to advise their trustees to exercise such a power without specific statutory authority, states began in 1992 to authorize such powers by statute. New York was the first state to enact decanting legislation. The legislative history of the New York act provides that it is consistent with and declaratory of existing common law.

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3 142 Fla. 782, 196 So. 299 (1940).
4 *Id.* at 786.
5 See also *Wiedenmayer v. Johnson*, 106 N.J. Super. 161, 254 A.2d 534 (App. Div., 1968). Wiedenmayer concerned an indirect decanting, however, in that the trustees exercised their power of invasion in favor of the beneficiary contingent on the beneficiary’s agreeing to transfer the property in further trust. The court concluded that the transfer was in the beneficiary’s best interests, describing “best interests” as follows: “The expression is not limited to a finding that distribution must be to the son’s best ‘pecuniary’ interests. His best interests might be served without regard to his personal financial gain. They may be served by the peace of mind, already much disturbed by matrimonial problems, divorce, and the consequences thereof, which the new trust, rather than the old contingencies provided for in his father’s trust indenture, will engender. Of what avail is it to rest one’s ‘best interests’ on a purely financial basis, and without regard to the effect upon a man’s mind, heart and soul, if the end result would produce a wealthier man, but a sufferer from mental anguish?”
6 See N.Y.E.P.T.L. section 10-6.6. See also Halperin and O'Donnell, supra note 2.
Legislation somewhat similar to that in New York now has been enacted in Alaska, Arizona, Delaware, Florida, Indiana, Missouri, Nevada, New Hampshire, North Carolina, Ohio, South Dakota, and Tennessee. We understand that the legislatures of several other states are considering similar legislation.

A power held by a trustee to invade the corpus of a trust is analogous to a power of appointment for property law purposes. As a general rule, the holder of a power of appointment may appoint the property in further trust. If the power to decant is held by a trustee, however, it is by definition a fiduciary power. The Comments to Restatement (Third) of Trusts, section 75, draw a distinction between powers held in a fiduciary capacity and those that are held for the power holder’s personal benefit (meaning without regard to any fiduciary obligation to the beneficiaries of the trust or the permissible appointees). The discussion echoes the Reporter’s Notes on section 64, which also draw a distinction between a personal power that may be exercised for the personal benefit of the donee of the power and a fiduciary power that must be exercised for the purpose for which the settlor created it. The Reporter’s Notes on section 64 indicate that if the power holder’s power is personal, then the trustee’s only duty is to ascertain whether the attempted exercise is or is not within the terms of the trust.

The donee of a personal power of appointment seems to have no affirmative duty to act in good faith, and appears to be able to exercise a power of appointment to exclude a person from beneficial enjoyment for personal reasons. A fiduciary, on the other hand, would be precluded by fiduciary duties from acting in a similar manner. Instead, a fiduciary will always be held to a minimum standard of good faith, with an obligation to act consistently with the terms of the trust and the interests of the beneficiaries.

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8 See supra note 1.
9 See Restatement (Third) of Property (Wills & Don. Trans.) §17.1 (2011) Comment g (“A fiduciary distributive power is a power of appointment (a nongeneral power), but it is not a discretionary power of appointment”). If the trustee can invade for his or her own benefit, then the power of invasion may constitute a general (estate taxable) power of appointment under Code sections 2514(c) and 2041(b). The power to invade for one’s own benefit (that is, to withdraw property from the trust) may cause the power holder to be the owner of the trust for purposes of Code section 671 so that the income, deductions, and credits against tax of the trust are attributed to the power holder. See Code section 678(a). If the power is held in a fiduciary capacity, however, Code section 678 may not apply. See Blattmachr, Gans, and Lo, “A Beneficiary as Trust Owner: Decoding Section 678,” ACTEC Journal (2009).
10 See, generally, Scott on Trusts, supra note 6 §3.1.2 at pages 144-45 (the trend is to construe the language conferring a power of appointment with increasing liberality, and to hold that the donee of the power has broad discretion as to the manner in which the power may be exercised). See, e.g., Restatement (Third) of Property: Wills & Other Transfers (Tentative Draft No. 5), §19.14 (except to the extent the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment, including an appointment in trust and an appointment that creates a power of appointment in another, that solely benefits permissible appointees of the power).
11 See Restatement (Third) of Trusts, section 50 (2003), Comment a (“A trustee’s discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power”).
12 See section 105 of the Uniform Trust Code, adopted in 2003 by the National Conference of Commissioners on Uniform State Laws, which prohibits a trust instrument from waiving a trustee’s duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.
Uses of Decanting

Trustees exercise their decanting powers for a variety of reasons, including to separate the beneficial interests of different beneficiaries and to modify certain provisions of the initial trust. Although we have defined decanting as a power exercisable without prior court approval or beneficiary consent, the original New York statute required court approval prior to the exercise of a decanting power. Accordingly, there is a body of case law under the original New York statute that provides guidance as to the permissible purposes for which a fiduciary may exercise a decanting power. The New York courts, for example, have permitted the use of trustees’ decanting powers for the following reasons:

1. Protecting the tax treatment of a trust.¹³
2. Granting a beneficiary a power of appointment, presently exercisable or otherwise.¹⁴
3. Reducing administrative costs.¹⁵
4. Altering trusteeship provisions such as the identity or manner of appointing fiduciaries.¹⁶
5. Extending the termination date of a trust.¹⁷
6. Converting a nongrantor trust to a grantor trust or the reverse.¹⁸
7. Changing a trust’s governing law.¹⁹
8. Dividing trust property to create separate trusts.
9. Reducing potential liability.²⁰

¹³ Matter of Ould, N.Y.L.J., 11/28/01, page 21, col. 5 (Surr. Ct., N.Y. County), in which the trustees were permitted to appoint the trust estate consisting of a second-to-die insurance policy to a new trust, thereby eliminating the Crummey power of withdrawal of one of the insureds.
¹⁴ See Phipps v. Palm Beach Trust Co., 142 Fla. 782, 196 So. 299 (1940). It seems quite apparent that granting a beneficiary a power of appointment is consistent with a trustee’s decanting power. Because the trustee could pay the principal of the trust directly to the beneficiary who could then give or bequeath the property to anyone in the world or expend it for his or her own benefit, granting the beneficiary a special or general power of appointment gives the beneficiary the same type of disposition or expenditure authority.
¹⁵ Matter of Vetlesen, N.Y.L.J., 6/29/99, page 27, col. 3 (Surr. Ct., N.Y. County), in which a sole trustee appointed principal of an inter vivos trust to himself and another as trustees of a testamentary trust and the trustees agreed to share one commission.
¹⁶ Matter of Klingenstein, N.Y.L.J., 4/20/00, page 33, col. 6 (Surr. Ct. Westchester County), in which limitations on number of individual trustees, powers to remove and replace trustees, requirement for a corporate trustee, designation of successor trustees, and ability of corporate trustee to appoint a successor were changed.
¹⁷ In re Alfred Hazan, N.Y.L.J., 4/11/00 (Surr. Ct. Nassau County), in which a trustee was permitted to extend a trust for a beneficiary’s lifetime. See also Matter of Dornbush (Riese), 164 Misc.2d 1028, 627 N.Y.S.2d 232 (Surr. Ct. N.Y. County, 1995), in which the corpus of an irrevocable trust subject to New York law, which was to end at the death of the first to die of the grantor and the beneficiary, was paid to a new Florida trust for the beneficiary’s lifetime in order to protect the trust assets from the beneficiary’s potential creditors.
¹⁸ See CCA 200923024, discussed below.
¹⁹ Matter of Dornbush (Riese), 164 Misc.2d 1028, 627 N.Y.S.2d 232 (Surr. Ct. N.Y. County, 1995) supra note 19, in which the trustees of two irrevocable trusts subject to New York law were allowed to pay over assets to substantially identical Florida trusts in order to protect the trusts’ assets from New York real property transfer gains taxes.
²⁰ Matter of Kaskel, 163 Misc.2d 203, 620 N.Y.S.2d 217 (Surr. Ct. N.Y. County, 1994), in which the trustees of several family trusts, which included spendthrift provisions, were allowed to terminate the existing trusts and pay over assets to new trusts without spendthrift provisions so that the beneficiaries could assign their interests in distressed real estate properties from the trusts to corporations, followed by an invasion of the principal of the trusts in favor of the corporations.
10. Converting a trust into a supplemental needs trust to permit a beneficiary to qualify for certain governmental benefits.  

11. Making trust interests spendthrift or the reverse.

Other common uses of decanting include (1) addressing changed circumstances, such as changes in applicable fiduciary law or changes in family circumstances or dynamics; (2) modifying administrative provisions, such as to change restrictions on investment powers or to create a “directed trust”; (3) correcting a drafting error without the necessity of going to court.

Common Statutory Decanting Provisions

Not all state decanting statutes are alike. However, there are common or parallel provisions. Some allow decanting only if the trustee’s power to invade the trust is “absolute.” Others permit invasions even if there is a fixed (e.g., ascertainable) standard for invasion, and at least one of the statutes requires that the invasion standard be the same in the trust to which the trust assets are decanted as it was in the invaded trust. Most expressly require that an income interest cannot be eliminated and must be preserved in decanting. Some but not all statutes provide that the decanting power cannot be used to extend the term of the trust beyond the rule against perpetuities applicable to the original trust.

A decanting power generally cannot be exercised to add to the class of beneficiaries of a trust. Instead, decanting authority derives from the trustee’s authority to make distributions to or for the benefit of current beneficiaries of the trust as described by the Florida Supreme Court in Phipps. And if a trustee may distribute property to or for the benefit of a beneficiary free of trust the beneficiary would be able thereafter to transfer the property to a non-beneficiary. Accordingly, the Phipps court permitted the trustee to grant a beneficiary a power of appointment by decanting whereby the beneficiary was authorized to appoint the trust estate to a non-beneficiary.

21 Estate of Grosjean, N.Y.L.J., 12/10/97, page 35, col. 6 (Surr. Ct. Nassau County). See also In re Estate of Alfred Hazan, supra note 19; Estate of Barkman, N.Y.L.J., 5/20/03, page 23, col. 3 (Surr. Ct., Nassau County), in which the court permitted the conversion even though the beneficiary had a fixed income interest.  

22 Matter of Rockefeller, N.Y.L.J., 8/24/99, page 28, col. 2 (Surr. Ct. Nassau County), in which a committee of individuals with discretionary distribution authority over a trust was permitted to pay trust assets to a new trust to protect the trust principal by providing a spendthrift restraint.  


24 See, e.g., Delaware Code Ann. Tit. 12 §3528.  


28 See, e.g., Florida Statutes §736.04117(1)(a):

Unless the trust instrument expressly provides otherwise, a trustee who has absolute power under the terms of a trust to invade the principal of the trust, referred to in this section as the “first trust,” to make distributions to or for the benefit of one or more persons may instead exercise the power by appointing all or part of the principal of the trust subject to the power in favor of a trustee of another trust, referred to in this section as the “second trust,” for the current benefit of one or more of such persons under the same trust instrument or under a different trust instrument; provided: ... The beneficiaries of the second trust may include only beneficiaries of the first trust....
Income and Transfer Tax Issues

The existence of and use of decanting powers, whether held in a fiduciary or non-fiduciary capacity, and whether held as a result of local common or statutory law or as a result of a provision in the original instrument, present a number of tax issues, including:

**Income Tax Issues**

1. Whether the existence of a decanting power causes the trust to be treated as a grantor trust under Code section 671 if the decanting power permits decanting from a non-grantor Distributing Trust to a grantor Receiving Trust.\(^{29}\)

2. Whether decanting a trust that is treated as owned partially or wholly by a person under Code sections 671 through 678 (a “grantor trust”) to one which is not a grantor trust is an income tax realization event.

3. Whether the distribution of property from one trust to another should be treated as a distribution for purposes of Code sections 661 and 662.

4. Whether the distribution of appreciated assets from one trust to another will cause the Distributing Trust to recognize gain under Code section 1001.

5. Whether the distribution of appreciated assets from one trust to another will cause any beneficiary of the Distributing Trust to recognize gain under Code section 1001.

6. Whether a trust that receives all of the assets of a decanted trust receives the tax attributes of that trust such as, for example, its capital loss and net operating loss carryovers, its deductions in excess of gross income for its last year, its accumulated gross income for purposes of determining permissible future deductions for distributions to charity, its passive loss carryforwards, and its carryforward of disallowed investment interest.

7. Whether the grantor of the Distributing Trust continues to be the grantor of the Receiving Trust following a decanting.

8. Whether the existence of a decanting power with regard to a qualified subchapter S trust (“QSST”) results in loss of QSST status.

**Gift and Estate Tax Issues**

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

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

\(^{29}\) All references to a “section” or “§” of the Code refer to the Internal Revenue Code of 1986, as amended.
3. Whether the existence of a decanting power in a trust that is required to have certain provisions to qualify for an estate or gift tax marital deduction under Code section 2056 or 2523 or for a gift tax exclusion under Code section 2503(c) will cause the trust to fail to qualify for the marital deduction or the gift tax exclusion.

4. Whether a requirement that beneficiary consent, court approval, or approval by the State Attorney General be obtained prior to the exercise of a decanting power will result in different gift tax consequences to a beneficiary than a decanting that does not require such approval.

5. Whether the donor of the Distributing Trust continues to be the donor of the Receiving Trust following a decanting.

**Generation-Skipping Transfer Tax Issues**

1. Whether a trust that has, by a decanting, received property from another trust that is protected from the GST tax by reason of the effective date rule of Chapter 13 or by reason of an allocation of GST exemption continues to enjoy that protection.

2. Whether decanted trust property that has an inclusion ratio of more than zero but less than one by reason of an allocation of GST exemption under Code section 2631 to the Distributing Trust will have that same inclusion ratio in the Receiving Trust.

3. Whether decanted trust property of a Distributing Trust that is not subject to Chapter 13 by reason of Code section 2663 retains that status following a decanting to a Receiving Trust.

4. Whether decanted trust property continues to have the same transferor for purposes of Chapter 13 following a decanting from a Distributing Trust to a Receiving Trust.

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

There is little developed law to assist taxpayers in answering these questions. Detailed guidance is important both for taxpayers and the Internal Revenue Service. Each of these issues is discussed more fully below in the form of questions and our proposed answers. The accompanying proposed Revenue Ruling does not attempt to propose guidance on each of these issues, but instead covers what we perceive to be the most common forms of decanting.

**Income Tax Issues**

1. Q. Code section 674(a) causes a trust to be treated as owned by its grantor while the grantor is living if any portion of the income or principal of the trust is subject to a power of disposition by any person without the consent of an adverse party. There are a number of exceptions to this rule, but none of the exceptions applies if any person has the power to add a beneficiary to the trust (other than afterborns or adopteds). When a trustee or other power holder has the power to decant to a Receiving Trust, should the Receiving Trust be treated as a “beneficiary”? If the Receiving Trust is treated as a beneficiary, would the Receiving Trust fail to qualify for the exceptions under Code section 674 because the trustee of the Distributing Trust would in effect be treated as having a power to add a
beneficiary to the original trust?  Code section 677 causes a trust to be treated as owned by its grantor while the grantor is living if any portion of the income or principal of the trust may be distributed to or accumulated for future distribution to its grantor.  If a Distributing Trust that is not a grantor trust may be distributed to a Receiving Trust that is a grantor trust, would that power cause the Distributing Trust to be treated as having a power to distribute income and principal to its grantor?

A. Trusts are held for the benefit of beneficiaries; but it seems inappropriate that trusts be treated as if they were beneficiaries for purposes of Code section 674 or Code section 677.  The treatment of a trust as a person is a convenient fiction for income tax purposes.  It enables the Code to impose income tax on them as if they were entities separate from the persons for whose benefit they are held.  The term “beneficiary” or “beneficiaries” for purposes of Code section 674 and Code section 677 is best limited to the person or persons for whose benefit a trust is held.  The power to distribute trust property to another trust, so long as that power does not permit the Receiving Trust to include persons as beneficiaries who were not beneficiaries of the Distributing Trust, ought not to disqualify a trust from the exceptions to Code section 674(a).  Similarly, while a grantor trust is treated as identical with its grantor for some purposes (so that, for example, a partnership interest held by a grantor trust is treated as owned by its grantor), that does not mean that a grantor trust is identical to its grantor for all purposes or that every grantor trust should be treated as providing a beneficial interest to the grantor.  If, for purposes of decanting, a grantor trust is treated as identical to its grantor, the decanting to a grantor trust might be viewed as identical to a distribution to the grantor, and under Code section 677 every trust would therefore be a grantor trust by reason of the grantor’s beneficial interest, particularly if the authority to decant can be found within the common law authority of a trustee to distribute property “for the benefit of” the beneficiaries of a trust.  It seems inappropriate to cause such a significant and unexpected consequence with respect to the income tax treatment of irrevocable trusts.  Accordingly, it seems most appropriate that the authority to decant not be treated as the authority to add a beneficiary to the original trust so long as the Receiving Trust resulting from the decanting is not permitted to include any beneficiary who was not also a beneficiary of the Distributing Trust.  Similarly, it seems appropriate that the authority to decant from a Distributing Trust that is not a grantor trust to a Receiving Trust that is a grantor trust not be treated, by itself, as authority to make distributions to or accumulate property for future distribution to the grantor of the Distributing Trust.

2. Q. A trust may be treated as owned partially or wholly by a person under Code sections 671 through 678 (a “grantor trust”) and that person will be treated for Federal income tax purposes, in whole or in part, as the owner of the assets held in trust.  As a result, to the extent the trust is a grantor trust, items of income, deduction, and credit will be attributed to the owner and reportable by the owner on the owner’s Federal income tax return.  A grantor may be treated as the owner of a trust under the following provisions of the Code:

   (1) If the grantor has retained a reversionary interest under Code section 673.
   (2) If the grantor or a non-adverse party has certain powers over the beneficial interests in the trust under Code section 674.
   (3) If certain administrative powers over the trust exist under which the grantor can or does benefit under Code section 675.

30 Code section 7701(a)(1).
(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor under Code section 676.

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor’s spouse under Code section 677.

In addition, a person other than the grantor may be treated as the owner of a trust under Code section 678 if that person possesses a power exercisable solely by himself to vest the income or corpus in himself or such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Code sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof. A trust may be changed from a grantor trust to a non-grantor trust or the reverse if the power or powers over the trust causing the trust to be a grantor trust are eliminated or introduced. If the power or powers are eliminated or introduced by decanting, would that cause the Distributing Trust or the Receiving Trust to realize income for income tax purposes?

A. As a general rule, it seems that the conversion of a nongrantor trust to a grantor trust is not a income tax realization event. In Revenue Ruling 85-13, 1985-1 C.B. 184, the grantor of a trust acquires the corpus of a trust in exchange for the grantor’s unsecured promissory note. The Revenue Ruling concludes that the transaction constitutes an indirect borrowing within the meaning of Code section 675(3), causing the borrower to be treated as the owner of the entire trust. The Revenue Ruling concludes further that the borrower becomes the owner of the trust and the owner of the property. But the Revenue Ruling concludes that the transition from nonowner to owner is not a sale for income tax purposes; therefore, no income tax realization event occurs. Rather, the conversion from a nongrantor trust to a grantor trust is treated as a mere gratuitous transfer of the property to the borrower, such that the borrower has a carryover basis rather than a cost basis in the property. On the other hand, Revenue Ruling 77-402, 1977-2 C.B. 222, holds that when a grantor and owner of a trust which holds a partnership interest subject to liabilities renounces all the grantor trust powers over the trust during the grantor’s lifetime, the grantor is treated as having transferred the interest in a sale that results in the recognition of gain or loss. That result, however, derives from a particular rule applicable to the transfer of an interest in a partnership under Code section 752(d) requiring realization if a partner’s share of partnership liabilities is reduced or eliminated by reason of a transfer or deemed transfer of a partnership interest. The result does not appear to apply generally except in the particular context of a trust holding a partnership interest subject to liabilities. The result follows from *Crane v. Commissioner*, which requires a taxpayer to include in the amount realized upon disposition of a property liabilities previously included in basis to the extent the transferee takes the property subject to those liabilities. Consistently with the foregoing authorities, Chief Counsel Advice 200923024 concludes that “the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor.” And it seems that the same result should apply in the case of a mere conversion of a grantor trust to a nongrantor trust, except to the extent that a special income tax rule overrides that result, as in the case of a trust that holds an asset with debt in excess of basis. For example, if the Distributing Trust were a grantor trust holding a partnership interest, and the partner/grantor’s share of partnership liabilities exceeded basis

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32 331 U.S. 1 (1947).
33 CCA 200923024 (December 31, 2008).
in the partnership interest, then a decanting to a Receiving Trust that is not a grantor trust would result in an income tax realization event.\textsuperscript{34}

3. \textbf{Q.} Code section 661 allows a trust to deduct in the calculation of its taxable income, with certain limitations, distributions the trust is required to make and distributions actually made that are permitted distributions. Code section 662 requires the beneficiaries who receive or are required to receive such distributions, again with certain limitations, to include such amounts in their gross incomes for the year. Should a distribution from one trust to another be subject to Code sections 661 and 662?

\textbf{A.} Although the Code does not specifically include a trust that can receive distributions from another trust within its definition of “beneficiary,”\textsuperscript{35} \textit{case law} suggests that one trust can be a beneficiary of another trust for purposes of Code sections 661 and 662 (in contrast, for example, to sections 674 and 677 discussed above).\textsuperscript{36} If a Distributing Trust distributes less than all of its assets to a Receiving Trust, it seems most appropriate that the distribution be treated as a distribution to a beneficiary for purposes of Code sections 661 and 662.

If, however, a Distributing Trust distributes all of its assets to a Receiving Trust, a better approach would be to treat the distribution as a mere recasting of the Distributing Trust and to treat the Receiving Trust as a continuation of the Distributing Trust. This seems to be the position the Internal Revenue Service took in PLR 200607015.\textsuperscript{37}

4. \textbf{Q.} Should the distribution of appreciated assets from a Distributing Trust to a Receiving Trust cause the Distributing Trust to recognize gain under Code section 1001?

\textbf{A.} If the distribution of appreciated assets from a Distributing Trust to a Receiving Trust is not made in satisfaction of an obligation (under the terms of the trust instrument of the Distributing Trust or otherwise) to distribute a fixed amount, Code section 643(e) would protect the Distributing Trust from gain recognition unless the trustee of the Distributing Trust elects to recognize gain under Code section 643(e)(3).

A more difficult question arises if the property distributed from a Distributing Trust to a Receiving Trust is subject to a liability in excess of its income tax basis (i.e., a “negative basis” asset). Under these circumstances, whether gain will be recognized under \textit{Crane v. United States}\textsuperscript{38} is uncertain. In this case, we assume that neither the Distributing Trust nor the Receiving Trust is a grantor trust. Under the \textit{Crane} doctrine, the amount realized, which will be used to determine tax profit or loss,


\textsuperscript{35} The Code does not contain a full definition of the term “beneficiary.” The closest thing to a statutory definition is Code section 643(c), which provides that the term “beneficiary” includes “heir, legatee, devisee.” The regulations provide further guidance by stating that “[a]n heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent’s will is a beneficiary of the decedent’s estate.” Treas. Reg. §1.643(c)-1

\textsuperscript{36} \textit{Lynchburg Trust & Savings Bank v. Commissioner}, 68 F. 2d 356 (4th Cir. 1934); \textit{Duke v. Commissioner}, 38 BTA 1265 (1938).

\textsuperscript{37} PLR 200607015 (November 4, 2005). See also PLR 200736002 (May 22, 2007).

\textsuperscript{38} 331 U.S. 1 (1947).
includes recourse and nonrecourse indebtedness discharged. There is no developed law as to whether Code section 643(e) overrides the Crane doctrine. Code section 643(e) provides that a Distributing Trust’s basis in distributed property carries over to the beneficiary and that the amount of the distribution is limited to the beneficiary’s basis in the distributed property. The argument that the Receiving Trust should receive a carryover basis is weakened, however, by the requirement in Code section 643(e) that the basis of the property distributed by the fiduciary to the beneficiary is “adjusted for ... any gain ... recognized to the ... trust on the distribution.”\(^{39}\) And in the case of a distribution of a “negative basis” asset, it appears that under the Crane doctrine the trust would recognize gain if the Receiving Trust is considered a different taxpayer for income tax purposes.

Regardless of how the negative basis issue is resolved in connection with a partial decanting of assets, in the case of a distribution of all (or substantially all) of the Distributing Trust’s assets to one or more Receiving Trusts, where there is no opportunity to select assets with reference to their bases, the better approach would be to treat the Receiving Trust or Trusts as continuations of the Distributing Trust. The result would be no gain recognition for the Distributing Trust and a carryover basis for the Receiving Trust or Trusts.

5. **Q.** Should the distribution of appreciated assets from one trust to another cause any beneficiary of the Distributing Trust to recognize gain under Code section 1001?

**A.** Normally, under Code section 662(a), a beneficiary may realize income by reason of a trust distribution only to the extent of the trust’s DNI. It is conceivable, however, that a “change” in a beneficiary’s interest in a trust could cause the beneficiary to realize income.

In *Cottage Savings Assn. v. United States*,\(^ {40}\) the Supreme Court held that a company realized a loss when it exchanged certain mortgage note interests for other such notes that were “materially different.” The Internal Revenue Service has indicated that it may treat a beneficiary as having realized gain under *Cottage Savings* where, for example, the beneficiary’s income interest is “converted” into a unitrust interest unless the conversion is pursuant to a state statute (or opinion of the highest court of the state).\(^ {41}\) Also, Treas. Reg. §1.643(b)-1 provides in part that a “switch” or conversion from an income interest to a unitrust interest, if “not specifically authorized by state statute but valid under state law (including a switch via judicial decision or a binding non-judicial settlement), may constitute a realization event to the trust or its beneficiaries for purposes of section 1001 [of the Code].”

Nevertheless, it seems that if the trustee were expressly authorized under the terms of the governing instrument or under applicable state law to change the beneficiary’s interest from an income interest

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\(^{40}\) 499 U.S. 554, 61 AFTR2d 91-808 (1991)

\(^{41}\) See PLR 200013015 (December 22, 1999) in which the Internal Revenue Service held that the partition of the trust and changes in administrative provisions pursuant to New York EPTL §10-6.6 would not cause the beneficiaries, whose interests remained the same in the “new” trusts as in the old, to realize gain under *Cottage Savings Assn.*, supra. But see PLR 200736002 (May 22, 2007), in which the IRS indicated that a beneficiary might realize gain if the beneficiary’s interest in a successor trust, pursuant to a pro rata division of a trust, was “materially” different than in the original trust, and PLR 200231011 (May 6, 2002), in which the IRS held, under *Cottage Savings*, that a court-approved settlement under which an annuitant received a unitrust interest instead of the annuity stream constituted an income-taxable exchange.
to a unitrust interest, the beneficiary would not realize gain when this occurs because the beneficiary’s interest in the trust was always subject to that potential conversion.\textsuperscript{42}

A partial answer also may be found in Treas. Reg. §1.1001-1(h), which deals with the severance of a trust (including without limitation a severance that meets the requirements of Treas. Reg. §26.2642-6 [the qualified severance Regulation] or of Treas. Reg. §26.2654-1(b) [retroactive severances at death]). It provides that a severance is not an exchange of property for other property differing materially either in kind or extent if an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust and any non-pro-rata funding, whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.

“Severance” for this purpose is not defined by the Code. It seems, however, that the term would include an action by the trustee, without judicial intervention or beneficiary consent, which is authorized by the governing instrument or applicable state law. Accordingly, if a complete decanting to a Receiving Trust may be treated as a continuation of the Distributing Trust, it seems most appropriate that a decanting to create more than one Receiving Trust be treated as a severance likewise having no gain realization consequences. Certainly, the qualified severance regulations treat certain divisions of a trust that produce new trusts with different beneficiaries as a severance.\textsuperscript{43} And Treas. Reg. §1.1001-1(h) does not appear to require a “qualified severance.” Instead, the result seems to turn on the ability of the trustee to take the action under the terms of the governing instrument or under state law.

Therefore, it seems that the exercise by a trustee of a decanting power, whether conferred under the instrument itself or pursuant to state law, would not result in any beneficiary realizing any gain or loss for Federal income tax purposes. It seems necessary to this conclusion that beneficiary consent, and possibly court approval—which indirectly may require that the beneficiary consent or at least acquiesce—not be required prior to the exercise of the decanting authority so that the beneficiary would not have the legal right to prevent the exercise of the decanting power.

6. **Q.** Does a Receiving Trust that receives all of the assets of a Distributing Trust succeed to the tax attributes of the Distributing Trust such as, for example, its capital loss and net operating loss carryovers, its deductions in excess of gross income for its last year, its accumulated gross income for purposes of determining permissible future deductions for distributions to charity, its passive loss carryforwards, and its carryforward of disallowed investment interest?

**A.** The answer to some of these issues can be found in Code section 642(h). This section provides that in the final year of a trust, its capital loss and net operating loss carryforwards and its deductions in excess of gross income for the year will be allowed as deductions to the beneficiaries who receive the trust property. There is no specific authority dealing with the balance of the issues. We believe that the simplest and most appropriate way to resolve these issues is to treat the Receiving Trust as a continuation of the Distributing Trust and to treat it as having received all of its tax attributes as well as its assets. This is the position the private foundation regulations take in connection with the

\textsuperscript{42} PLR 200810019 (November 20, 2007).

\textsuperscript{43} See, e.g., Treas. Reg. §26.2642-6(j), Example 2 (the trustee of a discretionary trust for T’s children, A and B, and their descendants, divides the trust pursuant to state law into two trusts, one for A and A’s descendants and one for B and B’s descendants; the “severance” constitutes a “qualified severance”).
distribution of all of the assets of a private foundation to another private foundation controlled directly or indirectly by the same persons.\textsuperscript{44}

In the case of a decanting to more than one Receiving Trust, it seems most consistent that the tax attributes be divided proportionately among the Receiving Trusts. This would appear to avoid any unfair income tax advantage or disadvantage to taxpayers as a consequence of decanting. Nevertheless, where a decanting involves less than all the assets of the Distributing Trust, or involves a decanting to multiple Receiving Trusts, we believe that the subject requires further study, and if there is such further study, the College would welcome the opportunity to supplement the analysis in this letter.

7. **Q.** Does the grantor of a Distributing Trust continue to be the grantor of each Receiving Trust following a decanting?

**A.** Treasury Regulation §1.671-2(e)(5) provides that if a trustee transfers property from one trust to another trust, the grantor of the recipient trust generally remains the same as the grantor of the original trust. This appears to be true whether the transfer to the Receiving Trust occurs as a result of a requirement under the terms of the Distributing Trust to make a distribution to the Receiving Trust or pursuant to an exercise of discretion by the trustee of the Distributing Trust to make a distribution to a Receiving Trust. Treasury Regulation §1.671-2(e)(5) provides that in the case where the distribution to the Receiving Trust is pursuant to the exercise of a general power of appointment within the meaning of Code section 2041, then the holder of the general power of appointment will become the grantor of the Receiving Trust, even if the Distributing Trust was a grantor trust with respect to another person. This shift in the identity of the grantor is consistent with the gift tax law, which treats a person who exercises a general power of appointment as the donor of the property transferred by the exercise under Code section 2514.

8. **Q.** Code section 1361(d) permits certain trusts to qualify as owners of Subchapter S stock (a so-called “qualified subchapter S trust” or “QSST”). Does the existence of a decanting power cause a trust to fail to qualify as a QSST?

**A.** Code section 1361(d)(3) sets forth the requirements for a trust to be a QSST. Those requirements include that there be only a single income beneficiary of the trust and that during the lifetime of the current income beneficiary corpus may be distributed only to that income beneficiary and any termination of the trust may occur only in favor of the current income beneficiary. If pursuant to applicable state law or the governing instrument the trustee of a QSST has decanting authority, the question arises whether that authority, by itself, disqualifies the trust as a QSST. If the Distributing Trust is a QSST, then the Distributing Trust would have fulfilled the requirements of Code section 1361(d)(3). As a general matter, decanting authority may be exercised only in furtherance of a trustee’s power to invade corpus of the Distributing Trust. Accordingly, it appears that a trustee’s authority to decant a Distributing Trust that is a QSST would be limited to a Receiving Trust for the exclusive benefit of the income beneficiary of the Distributing Trust. In addition, most state decanting statutes do not permit the reduction or elimination of an income interest in a trust. But even if the income interest could be reduced or eliminated, that possibility alone would not appear to violate the requirements for a QSST. Code section 1361(d)(3)(A)(i) requires simply that a QSST

\textsuperscript{44} Treas. Reg. §1.507-3(a)(9).
have only 1 income beneficiary. It does not require that the income beneficiary have a mandatory income interest. Instead, Code section 1361(d)(3)(B) requires that all of the income (within the meaning of Code section 643(b)) is distributed currently to the sole income beneficiary who is a U.S. citizen or resident. Accordingly, the mere possibility of reducing a mandatory income interest to a discretionary interest should not disqualify a Distributing Trust that is a QSST.

It is possible that by decanting or other means under applicable state law a provision in the Receiving Trust would disqualify the trust as a QSST. For example, in the Receiving Trust the current income beneficiary might be granted a lifetime power of appointment in favor of persons other than the current income beneficiary. It is not clear whether that possibility ought to disqualify a QSST from inception, rather than only at the time the power is in fact granted. The terms of the Distributing Trust would have met the requirements of a QSST. Indeed, strictly construing those requirements in the Distributing Trust may prohibit the trustee from decanting to a Receiving Trust that is not also a QSST. It also seems that a trustee of a Distributing Trust may be constrained from exercising its authority in a manner that conflicts with the tax purposes of the settlor under state law, if those purposes are expressed in or otherwise apparent from the governing instrument of the trust. In that case, state law would appear to prohibit the trustee from decanting a Distributing Trust to a Receiving Trust that is not also a QSST.

Gift and Estate Tax Issues

1. Q Does the reduction of a beneficiary’s interests in a Distributing Trust caused by a decanting of some or all of the assets of the Distributing Trust to a Receiving Trust result in a taxable gift by the beneficiary, whether the reduction occurs by granting another beneficiary a power of appointment, extending the duration of the trust, or excluding that beneficiary from the Receiving Trust?

A An individual makes a gift for federal tax purposes to the extent she transfers property worth more than what she receives, in money or money’s worth, in exchange. A beneficiary who neither created the Distributing Trust nor holds an immediately exercisable general power of appointment described in Code section 2514(b) would not normally be treated as making a gift when a trustee exercises distribution authority over the Distributing Trust, such as the power to invade principal for another trust beneficiary. It therefore seems appropriate that if the trustee distributes trust property in further trust pursuant to a decanting power, a beneficiary similarly not be treated as making a gift, regardless of whether the beneficiary’s interest is diminished and regardless of the means by which the interest is diminished. Instead, it seems appropriate that such a decanting be treated no differently for gift tax purposes than a distribution to an individual beneficiary of a multiple beneficiary discretionary trust.

The gift tax is imposed on the act of transfer of an interest in property by the donor. Treas. Reg. §25.2511-2(a) provides:

The gift tax is not imposed upon the receipt of property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the

45 Code section 2512.
transfer. On the contrary, the tax is a primary and personal liability of the donor, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

The regulation requires an act of transfer. If the act of transfer is not voluntary, ordinarily no taxable gift would be deemed to occur.

It therefore seems appropriate that a beneficiary not be treated as having made a taxable gift when a trustee exercises a decanting power in a manner adverse to his or her beneficial interest unless the beneficiary has a legal right to object to the exercise of the authority to decant. It seems appropriate that this result occur only if it is reasonable for the beneficiary to believe that such an objection would be sufficient to prevent such exercise, and only if the costs of pursuing such an objection are not unreasonable in light of the expected outcome of the objection.47

The grounds for objecting to the exercise of discretionary authority by a fiduciary under state law are generally quite narrow. Restatement (Third) of Trusts §50 (2003) provides as follows:

1. A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee.

2. The benefits to which a beneficiary of a discretionary interest is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor’s purposes in granting the discretionary power and in creating the trust.

As indicated, in general, a court will interpose on the exercise of a trustee’s discretion only in the case of an abuse of discretion.48 Accordingly, it appears that if a trustee exercises a decanting power consistently with state law, a beneficiary would be unable to prevent the exercise of the trustee’s discretion.

In addition, a trustee who is also a beneficiary and who is not permitted to make distributions to himself or herself, but is permitted to make distributions to other beneficiaries, might be treated as making a taxable gift on the exercise of such authority.49 Accordingly, a trustee who is also a beneficiary typically would be afforded tax protection either by a provision in the governing

47 Revenue Ruling 81-264, 1981-2 C.B. 185, confirms that a taxable gift can occur by permitting legal rights to expire. GCM 38584 relating to Revenue Ruling 81-264, acknowledges, however, that there may be circumstances where the taxpayer is able to show that the statute of limitations lapsed “in the ordinary course of business” based on the prospects of succeeding in litigation. See Treas. Reg. §25.2512-8.

48 See Commentary to Article 8, Section 814, of the Uniform Trust Code (last amended and revised in 2010) drafted by the National Conference of Commissioners on Uniform State Laws, approved and recommended for enactment by all States at its 113th year meeting (July 30 - August 6, 2004), citing Scott on Trusts, section 187.2 (4th Ed. 1988) (generally a court will not interfere with a trustee’s exercise of discretion if the trustee acts in good faith and does not act capriciously).

instrument, or by means of a state statute,\textsuperscript{50} that restricts distributions by a beneficiary who is also a trustee to an ascertainable standard of health, education, maintenance, and support within the meaning of Code section 2041(b)(2). Treas. Reg. §2511-1(g)(2) provides that if a trustee has a beneficial interest in trust property, the transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. If the beneficiary/trustee’s power is not so limited, her exercise of the power in a manner that diminishes her interest in the trust property would be treated as a taxable gift unless the beneficiary/trustee has sufficient control over the Receiving Trust to render the gift incomplete for gift tax purposes.

If the Receiving Trust confers on any beneficiary a power of appointment, and the trustee has the authority under applicable state law or the governing instrument to confer such a power, then consistent with the foregoing analysis, the grant of a nongeneral power of appointment to a beneficiary of the Receiving Trust would appear not to have gift tax consequences to any beneficiary of the Distributing Trust. As previously discussed, in \textit{Phipps}, the Florida Supreme Court held that a trustee with “absolute discretion” has the authority to decant to a Receiving Trust that confers on a beneficiary a nongeneral power of appointment. Similarly, if the trustee of the Distributing Trust has the authority under state law or the governing instrument to decant so as to delay the termination date of the Distributing Trust (whether this is accomplished by the terms of the Receiving Trust or a change to the governing law or situs of administration of the Distributing Trust), then consistent with the foregoing analysis, doing so would not appear to have gift tax consequences.

2. \textbf{Q.} Does the reduction of a beneficiary’s interests in a trust caused by decanting result in a transfer by the beneficiary for purposes of Code sections 2036 or 2038?

\textbf{A.} Rev. Rul. 95-58, 1995-2 C.B. 191, implies that powers described in Code sections 2036 or 2038 held by a trustee are attributed to the trust’s settlor (causing estate tax inclusion in the settlor’s estate) if the settlor may remove the trustee and name another as trustee, unless the settlor may not appoint herself or anyone who is related or subordinate to the settlor within the meaning of Code section 672(c) (sometimes referred to as an “independent trustee”). The Revenue Ruling provides a “safe harbor” avoiding the attribution of the trustee’s powers to the settlor if the settlor’s power to remove and replace a trustee is limited to the appointment of an independent trustee. This possibility of attribution of the trustee’s powers has been extended, unofficially, by the Internal Revenue Service to beneficiaries acting as trustees, potentially causing them to be deemed to hold a general power of appointment.\textsuperscript{51} But it seems appropriate that attribution not occur if the beneficiary is not deemed to have indirect control over the actions of the trustee by means of a removal and replacement power. Accordingly, it would appear consistent with existing principles that a beneficiary’s control over the identity of the trustee who has a decanting power be treated similarly to a beneficiary’s control over a trustee with distribution powers. Thus, if the power to remove and replace the trustee is constrained consistently with Revenue Ruling 95-58, a beneficiary should not be treated as making a transfer

\textsuperscript{50}See, e.g., New York EPTL 10-10.1 and Florida Statutes §736.0814(2) (formerly Florida Statutes §737.402(4)); see also, Rev. Proc. 94-44, 1994-2 C.B. 683 (holding that the enactment of the Florida statute curtailing the powers of a beneficiary/trustee to make distribution to himself to an ascertainable standard would not be treated as causing a lapse of a power of appointment for purposes of Code sections 2041(b)(2) and 2514(e).

\textsuperscript{51}See, e.g., PLR 200551020 (September 21, 2005).
within the meaning of Code section 2036 or 2038 when a trustee possesses or exercises a decanting power.

If a beneficiary is acting as a co-trustee such that the beneficiary can participate in the decanting authority, then the tax consequences to the beneficiary will depend upon the permissible terms of the Receiving Trust. If the authority of a beneficiary/trustee to exercise a decanting power preserves an ascertainable standard of invasion in the Receiving Trust such that Code section 2041 is not implicated, then, even if the beneficial interest of the beneficiary/trustee is reduced, it seems appropriate that such reduction not be construed as a transfer by the beneficiary for purposes of Code sections 2036 or 2038.

It also seems that the statement in many of the decanting statutes or a determination under the common law that the power to decant is to be construed as a nongeneral power of appointment would be enough to prohibit a beneficiary/trustee from participating in a decanting that would confer on the beneficiary/trustee an interest in the trust that could be tantamount to a general power of appointment.

The Delaware statute states that if the trust contains a standard, the exercise of the power to decant must be in furtherance of the standard. Other statutes simply permit a beneficiary/trustee to participate in the decanting only if distributions are limited to a standard. It seems appropriate that such a limitation on a beneficiary/trustee be inferred if the beneficiary/trustee is so limited in the Distributing Trust. Any contrary construction would appear to be an exercise of distribution authority by the beneficiary/trustee beyond the scope of the beneficiary/trustee’s authority in the Distributing Trust.

3. **Q.** Does the existence of a decanting power in a trust that otherwise qualifies for a gift or estate tax marital deduction under Code sections 2523 or 2056 or a gift tax exclusion under Code section 2503(c) cause the trust to fail to qualify for a marital deduction or a gift tax exclusion?

   **A.** To the extent the authority to decant is held in a fiduciary capacity such that the terms of the trust or applicable law governing the trust would prohibit a fiduciary from exercising any authority over the original trust in a manner that would be adverse to the best interests of the beneficiaries or violate a material purpose of the trust, it appears that the authority to decant would not permit a trustee to alter the terms of the trust in a manner that could disqualify the trust for its intended tax benefits. Accordingly, if the trustee’s authority to decant is subject to a duty to act consistently with the purposes of the trust and the best interests of the beneficiaries under applicable state law, then it appears that the trustee would be precluded from exercising the authority to decant in a manner that could alter the terms of the trust necessary to qualify for a marital deduction or gift tax exclusion such that the decanting authority, by itself, would disqualify a trust for such tax treatment. We believe it is appropriate that restrictions under the governing instrument or applicable state law be considered for purposes of determining whether the authority to decant may be exercised in a manner that could disqualify a tax sensitive trust from its original tax benefits. It also appears appropriate to consider whether language in the original trust instrument setting forth the intended purposes of the original trust is sufficient as a matter of state law to preclude a decanting power from being exercised in a manner that could disqualify the original trust. We believe that it would be a rare circumstance when decanting would be considered with respect to a marital deduction trust or a gift tax exclusion trust; accordingly, the accompanying proposed Revenue Ruling does not propose guidance with respect to such trusts.
4. **Q.** Does a requirement that beneficiary consent, court approval, or approval by the State Attorney General be obtained prior to the exercise of a decanting power result in different gift tax consequences to a beneficiary of the trust than a decanting that does not require such approval?

**A.** As previously explained, as a general rule, an individual makes a taxable gift only by engaging in a voluntary gratuitous transfer of property. If an individual permits legal rights to expire, a taxable gift can also occur. The question thus becomes whether the requirement of beneficiary consent, court approval, or the approval of the State Attorney General amounts to a legal right on the part of a beneficiary to avoid the decanting. In this regard, the approval of the State Attorney General would appear distinguishable because no beneficiary can control whether the State Attorney General approves the decanting or not. Instead, the requirement for approval of the State Attorney General would appear to represent an approval by an independent party that ought not to cause any tax consequence to a beneficiary. The requirement for beneficiary consent or court approval to the extent court approval cannot be obtained without beneficiary consent, has the potential to have gift tax consequences to a beneficiary. If a beneficiary can in effect block the decanting, then whether or not failing to exercise that right has tax consequences will depend on the effect of the decanting on the beneficiary’s interest in the Distributing Trust. If the beneficiary’s interest in the Distributing Trust is reduced, then it would appear that the beneficiary has made a taxable gift.

The tax consequences of reformations and modifications of trusts both of which require court approval seem relevant to the analysis. As a general matter, the law on reformation and modification of trusts is governed by the U.S. Supreme Court’s holding in *Commissioner v. Bosch.* In *Bosch,* the Supreme Court concluded that federal authorities, including the Internal Revenue Service, are not conclusively bound by a determination of a property interest made by a state trial court in a proceeding to which the United States is not a party. The Supreme Court determined to follow *Erie Railroad Co. v. Tompkins* to the effect that the state law as announced by the highest court of the state is to be followed. But “if there is no decision by that court then federal authorities must apply what they find to be the state law after giving ‘proper regard’ to the relevant rulings of other courts of the State.” Accordingly, if the decanting being sought is consistent with the law of the state whose law governs the trust, as declared by the highest court of that state, then it appears that the decanting would have no gift tax consequences to any beneficiary under *Bosch.* This would appear true even if beneficiary consent is obtained without being required to the extent the trustee’s authority to decant exists independently of the requirement for beneficiary consent.

It also seems relevant that a decanting by a trustee can have only prospective effect. Accordingly, a decanting, even if obtained with beneficiary consent and/or court approval, that extinguishes an interest or power prior to the time it becomes effective, would appear not to have tax consequences to any beneficiary. In Revenue Ruling 73-142, the decedent made substantial gifts of property to a trust for his wife and children. Under the terms of the instrument, the decedent reserved an unrestricted power to remove or discharge the trustee and appoint a new trustee, with no express

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52 Rev. Rul. 81-264, 1981-2 C.B. 185 (a taxpayer who permits his legal rights to collect a debt to expire makes a taxable gift to the borrower).
55 304 U.S. 64 (1938).
56 1973-1 C.B. 205.
limitation on so appointing himself. The trustee had an unrestricted power to withhold distributions and to apportion income and principal. The state court construed the decedent’s power to permit only one removal and appointment and to exclude the power to appoint himself a trustee. It appeared that the decree was contrary to the decisions of the highest court of the state. The Revenue Ruling concludes that *Bosch* does not void a lower court decree that is binding on the parties. Once the time for appeal elapses such that the decree is binding on the parties, the property rights of the parties are determined by the decree. Accordingly, the Code section 2036 and 2038 powers that might otherwise have attracted estate tax were extinguished prior to the taxing event, namely the death of the decedent. The decree extinguishing the powers would therefore be binding on the Internal Revenue Service, because the decedent did not possess the powers after the decree.

Accordingly, to the extent a court approved decanting does not itself have tax consequences, because, for example, a current property interest is thereby surrendered, a court approved decanting with prospective effect to eliminate a power with future tax consequences appears to avoid gift and future estate tax consequences so long as the court decree is thereafter binding on the taxpayer and cannot be undone.

5. **Q.** Does the donor of the Distributing Trust continue to be the donor of the Receiving Trust following a decanting?

   **A.** We believe that the answer to this question turns on whether a beneficiary or trustee is deemed to make a taxable gift as a result of the decanting. As previously explained, if a beneficiary could not prevent the exercise of decanting authority by the trustee, it would not appear possible for a beneficiary to have made a taxable gift. Accordingly, unless the exercise of decanting authority is deemed the exercise of a general power of appointment under Code sections 2041 and 2514 because the person with the authority to decant may exercise that authority in favor of himself, his creditors, his estate, or the creditors of his estate, the donor of the Receiving Trust should be the same as the donor of the Distributing Trust.

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**Generation-Skipping Transfer Tax Issues**

1. **Q.** Does a Distributing Trust that is protected from generation-skipping transfer tax by reason of being irrevocable on September 25, 1985 lose that protection as to property decanted to a Receiving Trust? Does a Distributing Trust exempt by reason of an allocation of GST exemption lose that protection as to property decanted to a Receiving Trust under the same circumstances as an effective date trust?

   **A.** Treas. Reg. §26.2601-1(b)(4)(i)(A) provides that a distribution of trust principal from a trust that was irrevocable on September 25, 1985 to a new trust will not cause loss of exempt status if the terms of the governing instrument or applicable state law at the time the trust became irrevocable authorizes the distribution to the new trust without the consent or approval of any beneficiary or court, and the terms of the governing instrument of the new trust will not extend the time for vesting beyond any life in being at the date the original trust became irrevocable plus a period of 21 years. Accordingly, so long as the decanting authority existed in the original trust and can be exercised without prior court approval or beneficiary consent, it appears under the regulation that the exercise of that authority has
no effect on the exempt status of a trust protected from the generation-skipping transfer tax by the effective date rule provided the new trust must terminate within the period set forth in the regulation.

None of the decanting statutes was in effect when the GST tax took effect. Thus, the requirement that state law authorize the distribution when the trust became irrevocable would not be met on the basis of such state statutes for trusts that are exempt by reason of the effective date rule. Nevertheless, as discussed above, it is at least arguable that a decanting power existed under the common law of all states.

A separate rule applies if decanting authority is exercised in a manner such that the vesting of interests is not postponed. Treas. Reg. §26.2601-1(b)(4)(i)(D) provides as follows:

A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Accordingly, changes that do not shift beneficial interests to lower generations should not cause loss of exempt status, even if done pursuant to a decanting statute enacted after the trust became irrevocable.

In addition, if decanting is accomplished by the exercise of a non-general power of appointment over the trust estate that existed at the time the trust became irrevocable, the new trust may continue for a standard rule against perpetuities period of lives in being when the original trust became irrevocable plus a 21 year term. Alternatively, the trust may continue for a period not to exceed 90 years from the date of creation of the original trust. Treas. Reg. §26.2601-1(b)(1)(v)(D), Example 4 provides that the exercise of a non-general power of appointment granted in a trust exempt from GST tax by reason of the effective date rule does not cause the trust to lose its exempt status if the exercise of the power

57 Certain trusts created after the initial effective date of the GST tax are exempted (e.g., where the settlor was incompetent); see Treas. Reg. §26.2601-1(b)(3). It is possible that one of the state decanting statutes might have been enacted for such special-date grandfathered trusts by the time such a trust became irrevocable.

58 See PLR 9737024 (June 17, 1997) (no loss of grandfathering where no change in quality, value, or timing of any beneficiary’s interest or power pursuant to decanting under New York EPTL 10-6.6); PLR 9804046 (October 28, 1997) (no loss of grandfathering where spendthrift provision changed by decanting under New York EPTL 10-6.6); PLR 200227020 (April 1, 2002) (no loss of grandfathering where situs of trust changed from New York pursuant to decanting under New York EPTL 10-6.6 where the trust would end at the same time); PLR 9438023 (June 17, 1994) (same).

59 In PLR 200227020 (April 1, 2002), the IRS ruled that grandfathering would not be lost in decanting a trust and explicitly noted that the new trust “will provide that, notwithstanding any other provision, no exercise of a power of appointment granted in the trust shall result in a termination date for a trust or a share thereunder or created pursuant to a power of appointment granted thereunder which is later than the date twenty-one years after the death of the survivor of all of Sister’s descendants living at Deceased’s death.”
does not suspend the vesting, absolute ownership, or power of alienation of an interest in the trust principal for a period, measured from the date of creation of the trust, beyond lives in being at the time the trust became irrevocable plus 21 years.

A generation-skipping trust may be exempt, in whole or in part, from GST tax not just by reason of the effective date rule but also by reason of an allocation of GST exemption to transfers to the trust.\textsuperscript{60} The Internal Revenue Service in private rulings has applied certain of the grandfathering rules to trusts that are exempt by reason of an allocation of GST exemption.\textsuperscript{61} Nevertheless, it remains uncertain under what circumstances the exercise of a state decanting power would cause such exemption from taxation to be lost.\textsuperscript{62} Many of the rulings addressing trusts exempt by reason of an allocation of GST exemption include the following language: “No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, it seems appropriate to conclude that a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, would similarly not affect the exempt status of such a trust.”\textsuperscript{63} Guidance confirming this principle would be beneficial to provide clarity and certainty to trustees acting under a trust that is exempt by reason of an allocation of GST exemption who propose to exercise a decanting power.

A question remains as to whether the limitation on the duration of a trust that receives the proceeds of an effective date trust under Treas. Reg. §26.2601-1(b)(4)(i)(A) (sometimes referred to as the “GST RAP”) should also apply to a trust that is GST tax exempt by reason of an allocation of GST exemption. The GST RAP reflects the common law rule against perpetuities that was in effect in most states at the time Chapter 13 was enacted, although Wisconsin and South Dakota had already permitted the unlimited duration of trusts. Under the law of many states, the common law rule has since been abolished in favor of permitting longer duration trusts.\textsuperscript{64} Suppose that at the time a trust that is exempt by reason of an allocation of GST exemption becomes irrevocable applicable state law permits the trust to continue for 360 years, but the governing instrument of the trust provides for an earlier termination date. Suppose that under a state decanting statute in effect at the time the trust became irrevocable the trustee has authority to extend the duration of the trust to 360 years from the date it became irrevocable. In that case, by analogy to Treas. Reg. §26.2601-1(b)(4)(i)(A)(2), it could be argued that even a valid postponement of vesting beyond lives in being when the Distributing Trust became irrevocable plus 21 years (or, alternatively, 90 years from the time the Distributing Trust became irrevocable) would still cause the Receiving Trust to lose its GST tax exemption. On the other hand, because the governing law at the time the Distributing Trust became irrevocable allowed both a 360-year term and decanting into a trust with a 360-year term, it could be argued that in the context of a comprehensive treatment of such issues in published guidance it is most consistent with the principles informing that guidance that the Receiving Trust would also be GST exempt. In either case, guidance on this point would be most helpful.

\textsuperscript{60} Code section 2631(a).
\textsuperscript{61} See, e.g., PLR 200551020 (September 21, 2005).
\textsuperscript{62} See PLR 9849005 (September 1, 1998) (holding that GST exemption allocation to a trust that made it exempt from the tax would continue if the trust were to use New York EPTL 10-6.6 to pay the corpus over to a trust with ‘identical’ terms).
\textsuperscript{63} See, e.g., PLR 200839025 (May 30, 2005).
In general, however, it appears appropriate to construe the existence of a decanting power applicable at the time the trust became irrevocable with respect to a trust exempt from GST tax by reason of an allocation of GST exemption as having no effect, by itself, on the exempt status of the trust. Similarly, it seems that the exercise of such a decanting power should also have no effect on the exempt status of the trust unless the decanting power itself constitutes a general power of appointment.

2. Q. Does a trust formed by decanting from a trust that has an inclusion ratio of more than zero but less than one have the same inclusion ratio as the original trust?

A. As a general matter, a division of a trust, other than by means of a qualified severance, will not cause a trust that is wholly or partially exempt from GST tax to be treated as a separate trust for GST tax purposes. Under Treas. Reg. §26.2642-6(h), however, trusts resulting from a severance that does not meet the requirements of a qualified severance will be treated, after the date of severance, as separate trusts for GST tax purposes, provided that the trusts resulting from such severance are recognized as separate trusts under applicable state law. Each trust resulting from a non-qualified severance will have the same inclusion ratio as that of the original trust immediately before the severance under Treas. Reg. §26.2642-6(h). Accordingly, it would be consistent with existing law that the consequences of a decanting be the same as a division of the trust under applicable state law, such that both the Distributing Trust and the portion of the Receiving Trust consisting of the decanted property would have the same inclusion ratio as the Distributing Trust.

3. Q. Does decanted trust property from a Distributing Trust that is not subject to Chapter 13 by reason of Code section 2663(2) relating to transferors who are nonresident aliens continue not to be subject to Chapter 13 if it is decanted to a Receiving Trust?

A. Code section 2663(2) and the Treasury Regulations promulgated thereunder contain special rules dealing with the application of GST tax to transfer by a nonresident not a citizen of the United States. As a general rule, Chapter 13 applies to such individuals only to the extent the transfer of property was subject to Chapter 11 or Chapter 12. Accordingly, it seems appropriate that a trustee’s power to decant property from a Distributing Trust created by a nonresident not a citizen of the United States to a Receiving Trust have an effect on the application of Chapter 13 to the Receiving Trust only if the exercise of the trustee’s power to decant was subject to Chapter 11 or Chapter 12 with respect to any person under the principles described above.

4. Q. Does decanted trust property have the same transferor for GST purposes following a decanting from a Distributing Trust to a Receiving Trust?

A. We believe that the answer to this question turns on whether a beneficiary or trustee is deemed to make a taxable gift or experience estate tax inclusion as a result of the decanting. As previously explained, if a beneficiary has no legal right to prevent the exercise of decanting authority, it would not appear possible for a beneficiary to have made a taxable gift. Accordingly, unless the exercise of decanting authority is deemed the exercise of a general power of appointment under Code sections 2041 and 2514 because the person with the authority to decant may exercise that authority in favor of himself, his creditors, his estate, or the creditors of his estate, the donor of the Receiving Trust should

See Code section 2654(b).
be the same as the donor of the Distributing Trust. If no taxable gift has occurred by reason of the exercise of decanting authority, then it appears that no shift in the identity of the transferor can occur for GST tax purposes. Similarly, unless decanting authority causes the value of any portion of the Distributing Trust to be included in the gross estate of any person, it would not appear that a shift in the identity of the transferor of the Distributing Trust can occur and the transferor of both the Distributing Trust and the Receiving Trust should be the same for GST tax purposes with respect to the decanted trust property.

5. **Q.** Can a trust that is not exempt from GST tax be decanted to permit effective allocation of GST exemption to only a portion of the original trust?

**A.** It is possible that the decanting of a trust pursuant to applicable state law might be construed as a severance that does not meet the requirements of a qualified severance. In that event, even though the severance is not qualified, after the date of severance the trusts will be recognized as separate trusts under state law.

Assuming the trusts are treated as separate trusts under state law, it seems appropriate that it be possible to allocate GST exemption to less than all of the trusts without being treated as having allocated GST exemption ratably to all the trusts. There would appear to be no tax abuse in permitting such an effective late allocation, as only the portion of the trust to which GST exemption is allocated would thereafter be treated as GST exempt. Indeed, GST exemption could be effectively allocated to the entire original trust, immediately followed by a qualified severance under Code section 2642(a)(3) such that one trust would be wholly exempt from GST tax and the other would be wholly subject to GST tax. Accordingly, there appears to be no reason not to permit a division of the trust by decanting, followed by an allocation of GST exemption only to one of the trusts so as to make that trust wholly exempt from GST tax.

If the severance results in a taxable termination or a taxable distribution as to a portion of the trust, for example because one of the trusts is a skip person, it would appear appropriate that the taxable event be deemed to occur only with regard to that particular resulting trust, with no GST tax impact on any other trust resulting from the severance. Each trust resulting from such a severance (prior to the allocation of any additional GST exemption) would have the same inclusion ratio as the original trust.

* * *

In addition to the comments in this letter, the College also submits a proposed Revenue Ruling setting forth a number of safe harbors covering the situation where decanting authority is conferred by state law upon a trustee with absolute discretion to distribute trust corpus of the original trust. The College believes that the situations covered in the proposed Revenue Ruling address the most common uses of decanting, not necessarily all issues discussed in this letter. The College believes that the issuance of such a Revenue Ruling would be a great assistance to taxpayers and their advisors in clarifying the federal tax consequences of the existence and exercise of decanting authority conferred under state law.

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Conclusion

These comments were prepared by Diana S.C. Zeydel (305-579-0575) (the principal author), Mary Ann Mancini (202-508-6263), and members of the College’s Estate and Gift Tax Committee and Fiduciary Income Tax Committee, and were reviewed and approved by Ronald D. Aucutt (703-712-5497) on behalf of the College’s Washington Affairs Committee. We appreciate this opportunity to comment with respect to Notice 2011-101 and would be pleased to offer additional comments if desired.

Respectfully submitted,

Louis A. Mezzullo

Enclosure: Proposed Decanting Revenue Ruling
PROPOSED DECANTING REVENUE RULING

Rev. Rul. 2012-XX

ISSUE

What are some of the estate, gift, income, and generation-skipping transfer (GST) tax effects of the exercise by an independent trustee of a power granted under state law to transfer property held in one trust to another trust for the benefit of one or more of the beneficiaries of the original trust, which power is exercisable without prior court approval or beneficiary consent?

FACTS

The trustee of an irrevocable trust (the “first trust”), created under the law of state X by will or other instrument, is authorized, under an express grant of authority under the governing instrument, to pay corpus of the first trust directly to the beneficiaries of the first trust. A statute of state X expressly authorizes the trustee of the first trust to transfer a portion or all of the corpus of the first trust to another trust (a “second trust”) for the benefit of one or more or all of those beneficiaries to whom the trustee could directly distribute the corpus of the first trust. The trustee’s authority under the statute of state X is exercisable without prior court approval and without the prior consent of any beneficiary of the first trust. The trustee’s authority to transfer corpus from the first trust to the second trust is exercisable notwithstanding any spendthrift or similar provision in the governing instrument or state law applicable to the first trust. No beneficiary has made a transfer for gift or estate tax purposes to the first trust and no beneficiary holds a general power of appointment over the first trust. In each situation, (i) no asset of the first trust consists of a policy of insurance on the life of any trust beneficiary, (ii) no beneficiary is a trustee of either the first trust or the second trust, and (iii) no beneficiary holds a power to remove any trustee of the first trust. In no situation do the terms of the governing instrument of the first trust authorize distributions to another trust.

Situation 1: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to one or more or all of the descendants of the settlor living from time to time in the trustee’s absolute discretion. The first trust terminates in 2015, whereupon the entire corpus and undistributed income will then be distributed to the settlor’s then living descendants, per stirpes. The trustee of the first trust, pursuant to the authority granted under a statute of state X, transfers the entire corpus of the first trust to a second trust declared by the trustee of the first trust for the benefit of some, but not all, of the settlor’s descendants. The second trust will terminate 21 years after the date of death of the survivor of the settlor’s descendants who were alive when the first trust became irrevocable. Upon its termination, the second trust will be distributed to the settlor’s then living descendants.
Situation 2: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to the sole life income beneficiary. The beneficiary does not hold a power of appointment with respect to the property of the first trust. The trustee of the first trust, pursuant to the authority granted under a statute of state X, transfers one-half of the corpus of the first trust to a second trust declared by the trustee under which the beneficiary of the first trust is entitled to all the income for life. The second trust grants the beneficiary a power to appoint the property of the second trust upon the beneficiary’s death among a class consisting of the descendants of the beneficiary living at the death of the beneficiary.

Situation 3: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to one or more or all of the descendants of the settlor living from time to time in the trustee’s absolute discretion. The trustee of the first trust, pursuant to the authority granted under a statute of state X, pays the entire corpus of the first trust to a second trust funded by someone other than the settlor of the first trust. Under the terms of the second trust, the trustee may pay the corpus of the second trust to one or more or all of the descendants of the first trust’s settlor in the trustee’s absolute discretion. The second trust grants one of the descendants of the settlor of the first trust a presently exercisable power to pay the corpus of the second trust at any time and from time to time to one or more of the spouses of the descendants of the settlor of the first trust, including the widow or widower of any descendant of the settlor of the first trust who has died.

Situation 4: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to the sole life income beneficiary. The trustee of the first trust, pursuant to the authority granted under a statute of state X, transfers the entire corpus of the first trust to a second trust declared by the trustee of the first trust and governed by the law of another state. The law of the state governing the second trust, unlike the law of state X, permits the trustee to convert the beneficiary’s income interest into a unitrust interest paying 5% per year of the annual value of the second trust’s corpus to the income beneficiary instead of the second trust’s fiduciary accounting income.

Situation 5: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to the sole life income beneficiary. The first trust requires that all investments be in publicly traded securities. The trustee of the first trust, pursuant to the authority granted under a statute of state X, transfers the entire corpus of the first trust to a second trust governed by the law of another state. The law of the state governing the second trust, unlike the law of state X, (i) permits the current beneficiary to remove the trustee and appoint another as trustee (other than the beneficiary so removing the trustee and other than anyone related or subordinate to the beneficiary within the meaning of Section 672(c)), (ii) permits the trustee of the second trust to make any prudent investment, and (iii) permits a trustee’s compensation to be greater than or less than a trustee’s compensation under the law of state X.
LAW AND ANALYSIS

In general, a trust (other than a trust that is considered owned by another under Subpart E of Part 1 of Subchapter J of Chapter 1 of the Internal Revenue Code commonly referred to as a “grantor trust”), is entitled to a deduction under Section 661(a) for the amount of property properly paid or distributed to a beneficiary, but not in excess of the trust’s distributable net income (DNI) defined in Section 643(a). Any amount so paid or distributed is included under Section 662(a) in the gross income of the beneficiary, but not in excess of the DNI. A trust may be treated as a beneficiary for purposes of Section 661(a) and Section 662(a). See Reg. § 1.643(c)-1.

Distributions from a trust (other than a grantor trust) are governed by Sections 651 and 652 if the trust is required to distribute all of its income as defined in Section 643(b), does not provide for any payment to charity, and makes no other distributions for the year. Such a trust is known as a “simple trust.” Distributions from a trust (other than a grantor trust) are governed by Sections 661 and 662 if the trust is not required to distribute all of its income as defined in Section 643(b) or, if the trust is required to distribute all of such income and the trust makes another distribution for the year or provides for a payment to charity. Such a trust is known as a “complex trust.”

Reg. § 1.643(b)-1 provides, in part,

For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, “income,” when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. ... A switch between methods of determining trust income
authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust’s grantor or any of the trust’s beneficiaries.

Section 2501 imposes a tax on the transfer of property by gift by an individual, resident or nonresident. Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2033 causes the value of property to be included in the gross estate of a decedent only to the extent the decedent had an interest in the property at the time of the decedent’s death. Sections 2036, 2037, and 2038 cause the value of property to be included in the gross estate of a decedent only to the extent the decedent during lifetime transferred the property. Section 2039 causes the value of an annuity or other payment receivable to be included in the gross estate of a decedent only as to such part of the annuity or other payment as is proportionate to that part of the purchase price therefor contributed by the decedent. Section 2040 causes the value of property to be included in the gross estate of a decedent only if the property was owned by the decedent with another as joint tenants with right of survivorship. Section 2041 causes the value of property to be included in the gross estate of a decedent only to the extent the decedent held a general power of appointment over the property. Section 2042 causes the value of proceeds of a policy of insurance on the life of a decedent to be included in the gross estate of the decedent to the extent the decedent possessed an incident of ownership in the policy or its proceeds are payable to the estate of the decedent.

In general, the value of a trust of which the decedent was a beneficiary but to which the decedent made no transfer during life is not included in the decedent’s gross estate unless the decedent held a general power of appointment over the trust at death within the meaning of Section 2041.

Chapter 13 of Subtitle B of the Internal Revenue Code imposes a generation-skipping transfer (GST) tax on any generation-skipping transfer as defined in Section 2611(a) of that chapter. In general, Chapter 13 does not apply to a generation-skipping transfer under a trust that was irrevocable on September 25, 1985 (referred to herein as a “GST exempt trust”). Reg. § 26.2601-1(b)(1)(i). The distribution of trust principal from a GST exempt trust to a new trust may cause the new trust to be subject to the provisions of Chapter 13 if the terms of the governing instrument of the GST exempt trust do not authorize distributions to the new trust without the consent or approval of any beneficiary or court and, at the time the GST exempt trust became irrevocable, state law did not authorize distributions to the new trust. Reg. § 26.2601-1(b)(4)(i)(A).

Reg. § 26.2601-1(b)(4)(i)(D)(I) provides, in part,
A modification of the governing instrument of [a GST exempt trust] (including a trustee distribution...) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation ... than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

In Situation 1, no beneficiary will be treated as making a gift and no beneficiary will be treated as recognizing gain or other income by reason of the transfer by the trustee of the corpus of the first trust to the second trust. Because the entire corpus of the first trust is paid to the second trust, no one other than the trustee, acting as such, has made a contribution to the second trust. Accordingly, the second trust will be considered for all income tax purposes to be the same trust as the first trust, if neither the first trust nor the second trust is a grantor trust with respect to any taxpayer. The taxpayer identification number of the first trust may be used by the second trust. The transfer of corpus from the first trust to the second trust will extend the time for vesting of a beneficial interest in the first trust. Accordingly, the transfer of corpus from the first trust to the second trust will cause the second trust to lose any grandfathering from GST tax under Reg. § 26.2601-1(b)(4)(i)(A).

In Situation 2, the transfer by the trustee of one-half the corpus of the first trust to a second trust under which the beneficiary holds a power to appoint the property upon the beneficiary’s death among a class consisting of the then living descendants of the beneficiary will cause the amount so distributed, not in excess of the DNI of the first trust, to be included in the gross income of the second trust, if neither the first trust nor the second trust is a grantor trust with respect to any taxpayer. The second trust is treated as a separate taxpayer and must obtain and use a taxpayer identification number different from the taxpayer identification number of the first trust. No beneficiary will be treated as making a gift and no beneficiary will be treated as recognizing gain or other income by reason of the transfer to the second trust, whether or not the first trust was a grantor trust with respect to any taxpayer. No generation-skipping transfer will be deemed to have occurred by reason of the transfer to the second trust if at least one of the current beneficiaries of the second trust is a non-skip person for GST tax purposes with respect to the first trust. The inclusion ratio for GST purposes of both trusts will be the same as the inclusion ratio of the first trust. The value of the second trust will not be included in the gross estate of the beneficiary who has been granted the special power of appointment exercisable at death by reason of the grant of the power. Any exercise of the special power of appointment in further trust with respect to a grandfathered trust should be analyzed under the principles illustrated in Situation 1.

In Situation 3, the transfer by the trustee of the corpus of the first trust to a second trust will cause all of the DNI of the first trust to be included in the gross income of the second trust if
neither the first trust nor the second trust is a grantor trust with respect to any taxpayer. The second trust is treated as a taxpayer separate from the first trust. The second trust must obtain and use a taxpayer identification number different from the taxpayer identification number of the first trust. No trust beneficiary will be treated as making a gift and no beneficiary will be treated as recognizing gain or other income by reason of the transfer to the second trust whether or not the first trust or the second trust is a grantor trust with respect to any taxpayer. In particular, the grant of a presently exercisable power of appointment to one of the descendants of the settlor of the first trust will not by itself cause any beneficiary to have made a taxable gift to any other beneficiary. The exercise of the power of appointment may result in a taxable gift by the descendant holding the power of appointment under Revenue Ruling 75-550, 1975-2 C.B. 357, if that descendant is also a beneficiary of the second trust. No generation-skipping transfer will be deemed to have occurred by reason of the transfer to the second trust if at least one of the current beneficiaries of the second trust is a non-skip person for GST tax purposes with respect to the first trust. The inclusion ratio for GST tax purposes of the second trust will be the same as the inclusion ratio of the first trust with respect to the portion of the second trust that consists of the transfer, and the settlor of the first trust will be treated as the transferor for GST tax purposes with respect to such portion. The portion of the second trust attributable to the transfer from the first trust will not be included in the gross estate of any of the trust beneficiaries by reason of the transfer.

In Situation 4, the transfer by the trustee of the corpus of the first trust to a second trust which is governed by the law of another state that has a statute that permits a trustee to convert an income interest in a trust to a 5% unitrust will not cause the beneficiary to recognize income or gain and no generation-skipping transfer will be deemed to have occurred. The inclusion ratio for GST purposes of the second trust will be the same as the inclusion ratio of the first trust. The value of the second trust will not be included in the gross estate of any trust beneficiary. The results would be the same if the income interest in the second trust is thereafter converted to a unitrust.

In Situation 5, the transfer by the trustee of the corpus of the first trust to the second trust which is governed by the law of another state that permits the current beneficiary to remove the trustee and appoint another as trustee, permits the trustee to make any prudent investment, and provides a method of fiduciary compensation so that the trustee’s compensation may be greater than or less than a trustee’s compensation under the law of state X will not cause any beneficiary to recognize income or gain, and no generation-skipping transfer will be deemed to have occurred. The inclusion ratio for GST purposes of the second trust will be the same as the inclusion ratio of the first trust. The value of the second trust will not be included in the gross estate of any trust beneficiary.

In each Situation, the trustee is neither the donor nor a beneficiary. It would not change the tax consequences if (i) decanting authority were conferred under applicable state law in effect at the time the first trust became irrevocable rather that in the governing instrument of the first
trust, (ii) the trustee were a beneficiary so long as the beneficiary/trustee has no authority to participate in the decanting, or (iii) the second trust were declared by someone other than the trustee of the first trust.

HOLDINGS

When the trustee of a trust, who is not a beneficiary of the trust and to which no trust beneficiary has made a transfer for estate or gift tax purposes, may, under applicable state law, exercise the trustee’s absolute discretion to distribute trust corpus directly to any one or more beneficiaries so as to transfer trust corpus to a second trust for one, some, or all of the trust beneficiaries of the first trust, such transfer is treated as a distribution to a beneficiary under whichever of subpart B or subpart C of part I of Subchapter J of the Code is applicable if neither the first trust nor the second trust is a grantor trust with respect to any taxpayer. Such a transfer will not cause any beneficiary to be treated as making a gift for Federal gift tax purposes, will not cause the value of the any of the trust property to be included in the gross estate of any beneficiary (except to the extent, if any, the beneficiary holds a general power of appointment over the trust property), and will not be treated as a generation-skipping transfer if at least one of the current beneficiaries of the second trust is a non-skip person with respect to the first trust. However, if the first trust was irrevocable on September 25, 1986 and the time for vesting of any beneficial interest in the first trust is extended, either the first trust or the second trust or both may become subject to Chapter 13.

DRAFTING INFORMATION
Delaware State Bar Association and Delaware Bankers Association  
Joint Response to  
IRS Notice 2011-101  

TABLE OF CONTENTS  

<table>
<thead>
<tr>
<th>DESCRIPTION</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>3</td>
</tr>
<tr>
<td>Background</td>
<td>4</td>
</tr>
<tr>
<td>Decanting statutes in general</td>
<td>4</td>
</tr>
<tr>
<td>Delaware decanting statute</td>
<td>4</td>
</tr>
<tr>
<td>Discussion of the issues raised in the Notice</td>
<td>7</td>
</tr>
<tr>
<td>TOPIC 1: A beneficiary’s right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary)</td>
<td>7</td>
</tr>
<tr>
<td>TOPIC 2: Trust principal and/or income may be used to benefit new or additional beneficiaries</td>
<td>9</td>
</tr>
<tr>
<td>TOPIC 3: A beneficial interest (including any power to appoint income or corpus whether general or limited, or other power) is added, deleted, or changed</td>
<td>9</td>
</tr>
<tr>
<td>TOPIC 4: The transfer takes place from a trust treated as partially or wholly owned by a person under §§ 671 through 678 of the Code (a &quot;grantor trust&quot;) to one which is not a grantor trust, or vice versa</td>
<td>10</td>
</tr>
<tr>
<td>TOPIC 5: The situs or governing law of the Receiving Trust differs from that of the Distributing Trust, resulting in a termination date of the Receiving Trust that is subsequent to the termination date of the Distributing Trust</td>
<td>10</td>
</tr>
<tr>
<td>TOPIC 6: A court order and/or approval of the state Attorney General is required for the transfer by the terms of the Distributing Trust and/or applicable law</td>
<td>11</td>
</tr>
<tr>
<td>TOPIC 7: The beneficiaries are required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law</td>
<td>11</td>
</tr>
<tr>
<td>TOPIC 8: The beneficiaries are not required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law</td>
<td>11</td>
</tr>
<tr>
<td>TOPIC 9: Consent of the beneficiaries and/or a court order (or approval) of the state Attorney General is not required but is obtained</td>
<td>12</td>
</tr>
<tr>
<td>DESCRIPTION</td>
<td>PAGE</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>TOPIC 10: The effect of state law or the silence of state law on any</td>
<td>13</td>
</tr>
<tr>
<td>of the above scenarios</td>
<td></td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>TOPIC 11: A change in the identity of a donor or transferor for gift</td>
<td>13</td>
</tr>
<tr>
<td>and/or GST tax purposes</td>
<td></td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>TOPIC 12: The Distributing Trust is exempt from GST tax under § 26.2601-1,</td>
<td>13</td>
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<td>Concluding remarks</td>
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August 13, 2012

VIA UNITED STATES MAIL
Room 5203
Internal Revenue Service
Post Office Box 7604
Ben Franklin Station
Washington, D.C. 20044

VIA ELECTRONIC MAIL
Notice.Comments@irs counsel.treasury.gov

Re: Delaware State Bar Association and Delaware Bankers Association Joint Response to IRS Notice 2011-101

INTRODUCTION

This response to IRS Notice 2011-101, 2011-52 I.R.B. 932 (December 20, 2011) (the “Notice”) is being submitted jointly by the Estates and Trusts Section of the Delaware State Bar Association and the Delaware Bankers Association. In addressing the issues raised in the Notice, we will discuss Section 3528 of Title 12 of the Delaware Code (the “Delaware decanting statute”), and apply the use of the Delaware decanting statute to the issues raised in the Notice. We will attempt to follow the order of the thirteen (13) points listed in the Notice for ease of reference and apply hypothetical scenarios to reflect practitioners’ actual usage of the Delaware decanting statute.

The Notice states that the Treasury Department and the IRS invite comments from the public regarding the income, gift, estate and generation-skipping transfer (“GST”) tax issues and consequences arising from transfers by a trustee of all or a portion of the principal of a Distributing Trust to a Receiving Trust that change beneficial interests. In reviewing writings on the tax implications of decanting, common themes emerge, and may be separated into categories of income tax, gift and estate tax, and GST tax. A summary of the issues can be found in the ACTEC response to the Notice. We first turn our attention to the Delaware decanting statute.


2 ACTEC, Tax Consequences of the Distribution of Trust Assets from One Trust to Another, supra.
BACKGROUND

Decanting statutes in general

The Delaware decanting statute is found in Section 3528 of Title 12 of the Delaware Code, and was originally enacted in 2003. In addition to the Delaware decanting statute, at the time of this writing the following twelve states also have decanting statutes: Alaska; Arizona; Florida; Indiana; Missouri; Nevada; New Hampshire; New York; North Carolina; Ohio; South Dakota; and Tennessee. Also, Illinois, Michigan, Rhode Island, and Virginia have bills under consideration that introduce decanting statutes. Our response focuses on the Delaware decanting statute, and its application in practice.

The Delaware decanting statute

The Delaware decanting statute permits trustees authorized to make outright principal distributions from a trust to one or more beneficiaries to instead appoint principal to the trustee of another trust for the benefit of one or more of the beneficiaries to whom the trustee could have made an outright distribution. Delaware’s decanting statute articulates the principle that, if a trustee may invade principal for a beneficiary under the terms of a trust agreement, the trustee may, in the exercise of its power to invade principal, distribute the principal of the first trust (“Distributing Trust”) to a second trust (“Receiving Trust”) for the benefit of some or all of the beneficiaries of the Distributing Trust.

The attributes of the Delaware decanting statute are as follows:

- The Distributing Trust must be created under a testamentary instrument or irrevocable inter vivos trust agreement.
- The Distributing Trust must not expressly prohibit the trustee from distributing assets in further trust for a beneficiary. 12 Del. C. § 3528(a).
- The trustee must have the ability to invade principal for the benefit of one or more of the beneficiaries of the Distributing Trust. 12 Del. C. § 3528(a).
- All of the beneficiaries of the Receiving Trust must also be beneficiaries of the Distributing Trust. 12 Del. C. § 3528(a)(1). The Receiving Trust may narrow or limit the permissible beneficiaries of the Distributing Trust, but it may not add beneficiaries who were not already proper objects of the power to invade the principal of the Distributing Trust.
- Although the Receiving Trust cannot add beneficiaries, and cannot accelerate the interests of remainder interests in the Distributing Trust, the Receiving Trust can grant a power of appointment

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5 12 Del. C. § 3528 (a).
6 In this Response, we will apply the terminology used in the Notice regarding trusts (i.e., “Distributing Trust” and “Receiving Trust”).
to any of the trust beneficiaries who are proper objects of the exercise of the power in the Distributing Trust. This power of appointment granted in the Receiving Trust can be general or special, and can be inter vivos or testamentary. 12 Del. C. § 3528(a). The legislative reasoning in recognizing the trustee’s authority to grant a power of appointment in the Receiving Trust is rooted in the notion that the trustee had the power to distribute the principal to the beneficiary outright, which, if exercised, would have given the beneficiary authority over the disposition of the principal so distributed.

- The Receiving Trust must comply with any standard that limits the trustee’s authority to make distributions from the Distributing Trust. If the Distributing Trust provides that distributions to the beneficiaries can only be made pursuant to an ascertainable standard, the Receiving Trust cannot provide that distributions can be made to the beneficiaries for a different purpose, 12 Del. C. § 3528(a). Note, however, there is no requirement that all of the standards have to apply in the Receiving Trust. For example, if the Distributing Trust has a standard of health, education, maintenance, and support, the Receiving Trust can be for the same standards or for any subset of the standards, such as education and health.

- The Distributing Trust must be sitused and administered in the State of Delaware. 12 Del. C. § 3528(c).

Section 3528(c) provides that the use of the statute to decant shall be considered the exercise of a power of appointment and shall be subject to the provisions of Chapter 5 of Title 25 of the Delaware Code covering the time at which the permissible period of the rule against perpetuities begins and the law which determines the permissible period of the rule against perpetuities. Under Delaware common law, the validity of the exercise of a limited power of appointment (and, by virtue of the reference in the Delaware decanting statute to the exercise of a power of appointment, the validity of a decanting transaction) is governed by Delaware law when the trust has its situs in Delaware at the time that the power is exercised. In 2011, this law was codified in 12 Del. C. § 3528(f). Subsection (f) of the Delaware decanting statute became effective on August 1, 2011 and applies to trusts whenever created. See Sections 7 and 19 of 78 Del. Laws Chp. 117 (formerly Senate Bill 83). The Synopsis to Senate Bill 83 indicates that Subsection (f) is intended to be a codification of Delaware common law. Notably, in accordance with Delaware common law, Subsection (f) does not require that a trust be governed by Delaware law in order for a trustee to avail itself of Delaware’s decanting statute. Accordingly, under Delaware law, even if the validity, construction and administration of a trust are governed by the law of another state, Section 3528 is available to and may be used by the trustee of a trust sitused and administered in Delaware in accordance with the statute’s terms.

- If the Distributing Trust qualifies for treatment as a minor’s trust under Section 2503(c) of the Internal Revenue Code (the “Code”), the beneficiary’s remainder interest in the Receiving Trust must vest and become distributable no later than the date upon which such interest would have matured under the Distributing Trust. 12 Del. C. § 3528(a)(2).

- The trustee’s exercise of decanting authority cannot reduce any income interest of any income beneficiary of a trust for which a marital deduction is taken under Section 2056 or 2523 of the Code or any comparable state law. 12 Del. C. § 3528(a)(3).

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\textsuperscript{7} Wilmington Trust Co. v. Wilmington Trust Co., 24 A.2d 309, 312 (Del. 1942).
• The trustee may provide in the instrument governing the Receiving Trust that, at a time or upon an event specified in the instrument, the assets of the Receiving Trust shall thereafter be held for the benefit of the beneficiaries of the Distributing Trust upon terms and conditions concerning the nature and extent of each such beneficiary's interest that are substantially identical to the terms and conditions of the Distributing Trust's governing instrument concerning such beneficial interests. 12 Del. C. § 3528(a). This means, among other things, that all of the provisions of the governing instrument of the Distributing Trust regarding beneficiaries other than those currently eligible to receive distributions (i.e., those who may be eligible to receive distributions in the future and remaindermen) may be preserved in the Receiving Trust.8

• The trustee's exercise of such decanting authority cannot apply to assets subject to a beneficiary's presently exercisable power of withdrawal if that beneficiary is the only person to whom, or for the benefit of whom, the trustee has authority to make distributions. 12 Del. C. § 3528(a)(4).

• The statute does not address the possibility of decanting income. Therefore, income cannot be decanted per se. However, if the trustee is empowered to accumulate income and add it to principal, then as a practical matter income also may be decanted. Also, if the instrument governing the Distributing Trust requires income to be distributed, a trustee could decant the principal to a trust where the income beneficiaries of the Distributing Trust are no longer eligible to receive income, subject to the limitation on marital deduction trusts described above.

• The statute requires that the trustee file with the records of the trust a writing signed and notarized by the trustee. 12 Del. C. § 3528(b). However, there is no requirement that notice be given to beneficiaries or that consents be obtained by beneficiaries, and there is no requirement to obtain judicial approval. Notice can be given to beneficiaries, and court approval can be sought, but there is no requirement in any form that the fiduciaries of the trust obtain consent from beneficiaries or any other interested parties.

• The trustee and any advisor directing or consenting to the trustee's decanting shall be held to the standard of care and the standard of liability applicable to the trustee and any such adviser when making outright distributions, free from trust, to or for the benefit of one or more permissible distributees. 12 Del. C. § 3528(e). Under Delaware law, when there is no distribution standard specified in an instrument, the exercise of discretion by a trustee will ordinarily be upheld by a court unless the trustee acted in bad faith or in an arbitrary and unreasonable manner.9

• The statute has no specific prohibition against decanting from a trust of limited duration to a Receiving Trust of longer duration than the Distributing Trust, including to a Receiving Trust of perpetual duration.

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8 Pulsifer, supra at page 4.
DISCUSSION OF THE ISSUES RAISED IN THE NOTICE

The Notice states the following:

“The facts and circumstances that the Treasury Department and the IRS have identified as potentially affecting one or more tax consequences include the following:

1. A beneficiary’s right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary);
2. Trust principal and/or income may be used to benefit new (additional) beneficiaries;
3. A beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;
4. The transfer takes place from a trust treated as partially or wholly owned by a person under §§ 671 through 678 of the Code (a “grantor trust”) to one which is not a grantor trust, or vice versa;
5. The situs or governing law of the Receiving Trust differs from that of the Distributing Trust, resulting in a termination date of the Receiving Trust that is subsequent to the termination date of the Distributing Trust;
6. A court order and/or approval of the state Attorney General is required for the transfer by the terms of the Distributing Trust and/or applicable law;
7. The beneficiaries are required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;
8. The beneficiaries are not required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law;
9. Consent of the beneficiaries and/or a court order (or approval of the state Attorney General) is not required but is obtained;
10. The effect of state law or the silence of state law on any of the above scenarios;
11. A change in the identity of a donor or transferor for gift and/or GST tax purposes;
12. The Distributing Trust is exempt from GST tax under § 26.2601-1, has an inclusion ratio of zero under § 2632, or is exempt from GST under § 2663; and
13. None of the changes described above are made, but a future power to make any such changes is created.”

TOPIC 1: A beneficiary’s right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary)

Assume that the Distributing Trust provides that the beneficiary, now age twenty-five (25), may receive income and principal from the trust solely in the discretion of the trustee for the beneficiary’s health, education, maintenance, and support until the beneficiary reaches the age of twenty-five (25). At the age of twenty-five (25) the beneficiary is entitled to receive all net income from the trust, but is still a discretionary beneficiary as to principal. At the age of thirty (30), the beneficiary is entitled to receive all of the assets of the trust outright, free of further trust. If the beneficiary dies before reaching the age of thirty (30), the principal of the trust continues in further trust for descendants of the settlor, under the same terms. If at any time there are no descendants of the settlor, the trust is paid outright to the family foundation or other charitable organizations.
Under the Delaware decanting statute, the trustee could decant the principal into a new or existing Receiving Trust with the same provisions as the Distributing Trust, except the beneficiary does not receive the assets outright until reaching age fifty (50). The trustee may exercise its discretion to do so if the trustee believes it is in the beneficiary’s best interest, under the trust’s standard for exercising discretion, to extend the time when the assets are protected from the beneficiary’s creditors, or to protect the beneficiary himself or herself.

Assume that the trustee decants to a new Receiving Trust created by the trustee for this purpose. The trustee is required to file a writing that is acknowledged with the trust records of the Distributing Trust. It is likely that the trustee will also file such a writing with the records of the Receiving Trust. There being no requirement under the Delaware decanting statute for notice to be given to the beneficiary or for court approval, the trustee gives no notice and obtains no court approval.

Income tax implications

There should be no income tax implications to the trustee, the trusts or the beneficiary, as there is no realization event or functional change in ownership as a result of the exercise of the trustee’s discretion to decant.

Gift tax implications

There should be no gift tax implications. As noted above, the Delaware decanting statute is centered on and derived from the discretionary power of a trustee to invade the principal of a trust for a beneficiary under the terms of a trust agreement. Any transfer by a trustee pursuant to such power should not be treated as a gift by a beneficiary, nor should it be treated as a gift by the trustee unless either: (1) the trustee exercising the power to decant is the beneficiary and is subject to no limitation,10 or (2) the beneficiary’s consent is required to exercise the trustee’s power to decant.11 The gift tax implication of a beneficiary’s consenting to the decanting is discussed in Topic 9 infra, and the gift tax implication of a beneficiary’s not objecting to the decanting is discussed in Topic 8 infra.

Estate tax implications

No estate tax issue should arise solely by reason of the exercise of the trustee’s discretionary decanting powers as described in this example. The trustee’s exercise of discretion is not itself a triggering event for federal estate tax purposes. The trustee’s scope of discretionary authority is given to the trustee by the trust creator in the first instance and includes decanting as confirmed by the Delaware legislature. Upon the trustee’s exercise of discretion to change the age for vesting to age fifty (50), the beneficiary has no ownership of the trust assets until then, and no potential federal estate tax arises in the event of the beneficiary’s death after age thirty (30) and before age fifty (50).

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10 See Treas. Reg. § 25.2511-1(g)(1), (2) which provides that generally a distribution by a trustee is not a taxable gift, but a distribution by a trustee with a beneficial interest in the property may be a taxable gift unless limited by an ascertainable standard. Delaware’s response to this potential issue is contained in 12 Del. C. § 3314 (c), which limits fiduciary powers in this context, thereby protecting the trustee with a beneficial interest from inadvertent tax consequences related to certain discretionary powers.

11 See e.g., Cerf v. Comm’r, 141 F. 2d 564 (3rd Cir. 1944); see also I.R.S. Priv. Ltr. Rul. 200917004 (April 24, 2009).
GST tax implications

There should be no GST tax implications. See Topic 12 infra for a discussion of GST tax implications in this type of scenario.

TOPIC 2: Trust principal and/or income may be used to benefit new or additional beneficiaries

The Delaware decanting statute does not permit the addition of new or additional beneficiaries.

TOPIC 3: A beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed

Assume that the trust instrument for the Distributing Trust provides that the trustee may distribute principal and income to or for the benefit of a beneficiary during the beneficiary’s lifetime. Upon the death of the beneficiary, the trust is paid outright to the descendants of the beneficiary, per stirpes.

Under the Delaware decanting statute, the trustee could decant the principal into a new or existing Receiving Trust with the same provisions as the Distributing Trust, except that the life beneficiary has a power to appoint the property of the trust by his or her will or other testamentary instrument, whether outright or in trust, in favor of any person or persons, including the beneficiary, the beneficiary’s creditors, the beneficiary’s estate or the creditors of the beneficiary’s estate.

Assume that the trustee decants to a new Receiving Trust that is created by the trustee for this purpose. The trustee is required to file a writing that is acknowledged with the trust records of the Distributing Trust. It is likely that the trustee will also file such a writing with the records of the Receiving Trust. Assume no notice to the beneficiary or court approval in that, as stated above, there is no requirement under the Delaware decanting statute for notice to the beneficiary or for court approval.

Income tax implications

There should be no income tax implications to the trustee, the trusts or the beneficiary, as there is no realization event or functional change in ownership as a result of the exercise of the trustee’s discretion to decant.

Gift tax implications

There should be no gift tax implications. See discussion in Topic 1 supra.

Estate tax implications

In this example, the granting of the general power of appointment to the beneficiary in the instrument governing the Receiving Trust could result in the imposition of federal estate tax at the death of the beneficiary holding the power of appointment, or if the beneficiary releases the power of appointment during his or her lifetime. Section 2041(a)(2) of the Code provides that the value of a decedent’s gross estate shall include the value of property with respect to which the decedent has at
the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released a general power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in his or her estate under Sections 2035 through 2038 of the Code. Generally, for purposes of Code § 2041, a general power of appointment means a power which is exercisable in favor of the decedent, his estate, or the creditors of his estate.\textsuperscript{12}

If this example provided that the power of appointment granted to the beneficiary could be exercised in favor of any person other than the beneficiary, the beneficiary’s estate, the beneficiary’s creditors or the creditors of the beneficiary’s estate, the grant of such power of appointment by a decanting should not, in and of itself, cause estate tax consequences for the beneficiary. However, we note that under current Delaware and federal law it is possible for the beneficiary to trigger federal estate inclusion for himself or herself if the beneficiary exercises his or her limited power in a manner which creates another power of appointment that can be exercised to postpone the vesting of the trust property without regard to the date of the creation of the beneficiary’s power of appointment (colloquially referred to as the “Delaware tax trap”).

In this example, the trustee’s exercise of its power to appoint the property in favor of a new trust that grants the life beneficiary a testamentary general power of appointment that may be exercised to create further trusts should not trigger the Delaware tax trap with respect to the trustee and cause the property of the Receiving Trust to be included in the trustee’s federal gross estate (if applicable). Legislative history indicates that the Delaware tax trap was not intended to apply to a fiduciary’s power of appointment, such as the trustee’s discretionary power to distribute income or principal to or for the benefit of the life beneficiary in this example.\textsuperscript{13}

**GST tax implications**

There should be no GST tax implication in that there is no skip by virtue of the exercise of discretion to give the beneficiary a general power of appointment.

**TOPIC 4: The transfer takes place from a trust treated as partially or wholly owned by a person under § § 671 through 678 of the Internal Revenue Code (a “grantor trust”) to one which is not a grantor trust, or vice versa**

We agree with the comments in the Report of Individual Members of the American College of Trust and Estate Counsel on the Tax Effect of Decanting that the mere conversion of a nongrantor trust to a grantor trust would not appear to have tax consequences.\textsuperscript{14}

**TOPIC 5: The situs or governing law of the Receiving Trust differs from that of the Distributing Trust, resulting in a termination date of the Receiving Trust that is subsequent to the termination date of the Distributing Trust**

Under Delaware law, the duration of a trust and time of vesting of interests in the trust property does not change merely because the place of administration of the trust is changed from some other

\textsuperscript{12} See I.R.C. § 2041(b)(1).

\textsuperscript{13} See S. REP. No. 82-382, at 1 (1951), as reprinted in 1951 U.S.C.C.A.N. 1535, 1535.

\textsuperscript{14} See Report of Individual Members of ACTEC, supra.
jurisdiction to Delaware. Accordingly, even though Delaware may have a longer perpetuities period than the state in which the Distributing Trust was located, there would be no changes in the termination date of the trust if only the trust’s administrative law changes to Delaware, while construction and validity remain governed by the law of the first jurisdiction. To make clear that the termination date of the Receiving Trust is not later than the termination date of the Distributing Trust, the terms of the Receiving Trust could require that Delaware law applies only to administration, and not to validity or construction. Moreover, even if the Receiving Trust is silent on the law governing administration, Delaware law would apply as to administration as long as the trust is administered in Delaware.

The potential GST tax implications are discussed in Topic 12, infra. There are no income, estate and gift tax implications.

**TOPIC 6: A court order and/or approval of the state Attorney General is required for the transfer by the terms of the Distributing Trust and/or applicable law**

The Delaware decanting statute does not require court approval, nor notice to or approval of the Attorney General of any state.

**TOPIC 7: The beneficiaries are required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law**

The Delaware decanting statute does not require beneficiaries to consent to the decanting. Moreover, the statute does not require that notice be given to the beneficiaries or any other parties.

**TOPIC 8: The beneficiaries are not required to consent to the transfer by the terms of the Distributing Trust and/or applicable local law**

The absence of a requirement to obtain the beneficiaries’ consent to the transfer under either Delaware law or the Distributing Trust should have no income, gift or estate, or GST tax implications.

While it might be argued that a beneficiary could be seen as making an indirect gift to other beneficiaries by consenting or failing to object to a decanting that reduces the beneficiary’s interest in the trust, the argument is misplaced. There is no preemptive right of a beneficiary to disallow a decanting, nor is there a legal right to object to a decanting. As discussed above, the trustee is acting in its discretion. Being a matter of trustee discretion, no beneficiary approval or consent arises. Similarly, the trustee’s decision to decant is not altered by a beneficiary’s withholding of consent. To prevent a decanting, a beneficiary would have to prove that the trustee abused the trustee’s discretion. To the extent the trustee exercises the trustee’s decanting power consistent with state law, no beneficiary would be able to block the decanting.

The Delaware decanting statute provides that the trustee be held to the standard of care and the standard of liability applicable to the trustee when making outright distributions, free from trust, to or for the benefit of one or more permissible distributees. Furthermore, Delaware law provides that

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15 12 Del. C. § 3332(a).
16 12 Del. C. § 3332(b).
17 ACTEC, Tax Consequences of the Distribution of Trust Assets from One Trust to Another, supra, page 12.
18 12 Del. C. § 3528(e).
where discretion is conferred upon a fiduciary with respect to the exercise of a power, its exercise by the fiduciary shall be considered to be proper unless the court determines that the discretion has been abused within the meaning of § 187 of the Restatement (Second) of Trusts, and not §§ 50 and 60 of the Restatement (Third) of Trusts. The Restatement (Second) provides that under the “good faith” test, even if there is a definite standard provided in the trust instrument (i.e., support) by which the reasonableness of the trustee’s actions can be measured, the trustee’s action will not be overturned “as long as the trustee acts in a state of mind in which it was contemplated by the settlor that he would act.” Therefore, even if a trustee acts beyond the bounds of reasonable judgment, this by itself might not be sufficient grounds to allow a court to overrule the trustee as long as he acts in “good faith.”

Based on the foregoing, there is no basis for asserting that the absence of requiring consent results in a taxable event. The consent or lack of consent is not material or requisite to the exercise of discretion to decant. Under Delaware law, a trustee is not required to give notice to or obtain the consent of a beneficiary regarding a decanting; therefore, it is possible that a beneficiary would not know of its reduction in interest until after completion of the decanting. In view of the position under Delaware law approving the trustee’s decision in the absence of an abuse of discretion, a challenge to decanting by a beneficiary after the fact, would not have a high probability of success to the extent facts are not supportive.

**TOPIC 9: Consent of the beneficiaries and/or a court order (or approval of the state Attorney General) is not required but is obtained**

This is a fact pattern that is frequently seen under Delaware practice. Although a beneficiary’s consent is not required under the Delaware decanting statute, frequently a trustee may want to obtain such consent before proceeding with a decanting. It is not uncommon for a trustee to want to be sure that the beneficiary will not bring a cause of action at a later time. Under Delaware law, a beneficiary may not hold a trustee liable for a breach of trust if the beneficiary consented to the conduct constituting the breach, released the trustee from liability for the breach, or ratified the transaction constituting the breach unless the consent, release or ratification was induced by improper conduct of the trustee, or at the time of the release the beneficiary did not know if his or her rights or material facts that the trustee knew or should have known.

Suppose that the trustee is considering decanting from a trust where the children of the settlor receive income and/or principal in the discretion of the trustee for the health, education, maintenance, or support of the beneficiaries. The new Receiving Trust will omit one of the children, as that child has already been provided for in other estate planning dispositions. Assume that the child who will be omitted is an adult, competent to consent to the decanting. An argument could be made that by voluntarily consenting to the decanting where the beneficiary will have a lesser value in the new trust, he or she is making an indirect gift to the other beneficiaries.

It is our opinion that whether a beneficiary is making a gift by consenting to a decanting that shifts his or her beneficial interest in the trust, or delays the vesting of his or her property interest in the trust, should be determined under the principles of Commissioner v. Bosch, 387 U.S. 456 (1967). Under Bosch, the U.S. Supreme Court determined that if a decanting is consistent with state law, the decanting

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19 12 Del. C. § 3315(a).
20 Restatement (Second) of Trusts §187, comment (j).
21 12 Del. C. § 3588.
should have no gift tax consequences to any beneficiary who is not also a trustee. As discussed under Topic 8, supra, a beneficiary has no legal right under Delaware law to object to a decanting, therefore, the failure to object should not constitute a taxable gift. Similarly, a beneficiary’s consent to a decanting would have no legal impact on the completion of the decanting, so no taxable gift should result.

**TOPIC 10: The effect of state law or the silence of state law on any of the above scenarios**

The foregoing responses of this comment address the effects of or the silence of Delaware law on the above scenarios.

**TOPIC 11: A change in the identity of a donor or transferor for gift and/or GST tax purposes**

The Delaware decanting statute does not have a mechanism that provides for a change in the identity of a donor or transferor.

**TOPIC 12: The Distributing Trust is exempt from GST tax under § 26.2601-1, has an inclusion ratio of zero under § 2632, or is exempt from GST under § 2663**

Trusts that were created prior to September 25, 1985 ("grandfathered" trusts) are exempt from GST tax. Treas. Reg. § 26.2601-1(b)(1)(i). The Treasury Regulations provide no general rule regarding what action would cause loss of grandfathered status. However, the regulations do set forth certain safe harbors that apply to decantings or modifications of grandfathered trusts, and provide that any change to a grandfathered trust that does not meet one of the regulatory safe harbors will taint the trust and cause a loss of the trust’s exempt status.22 Safe Harbor #1, dealing with “Discretionary Powers,” and Safe Harbor #2, dealing with “Other Changes,” under Treas. Reg. § 26.2601-1 are generally cited in discussing this issue.23 To preserve GST exempt status under Safe Harbor #1, a discretionary distribution of trust property from a grandfathered trust must meet three requirements:

I. On the date the grandfathered trust becomes irrevocable, either the terms of the trust or state law must authorize distributions to the new trust;

II. The trustee must be able to exercise the power to withdraw without the consent or approval of any beneficiary or court; and

III. The new trust cannot postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in the property beyond the shorter of the rule against perpetuities of the state or the federal perpetuities period of 90 years.

The issue under Safe Harbor #1 tends to be that decanting statutes were enacted after the grandfathering date of September 25, 1985, and therefore state law could not have authorized distributions to new trusts created prior to September 25, 1985. However, the argument is made that decanting is a common law limited power of appointment in the hands of the trustee, which has existed in most states prior to September 25, 1985, and the decanting statutes are merely codification of this common law. There are several cases often cited to demonstrate the use of decanting at common

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Therefore, depending on the controlling state law, the requirement that state law authorize distributions to a new trust when the grandfathered trust became irrevocable arguably could be met.

If the decanting does not satisfy Safe Harbor #1, then Safe Harbor #2 provides that the distribution will not taint the GST exemption if the following two requirements are met:

I. The modification does not shift a beneficial interest in the trust to any beneficiary occupying a lower generation than the person or persons holding beneficial interests in the trust prior to the modification; and

II. The modification does not extend the time for vesting any beneficial interests beyond the period provided for under the terms of the grandfathered trust instrument.

Notably, Safe Harbor #2 does not require that the decanting statute be in existence at the date the trust became irrevocable. However, to use this safe harbor, it is imperative that the vesting period in the trust not be extended and that beneficial interests are not shifted to any persons occupying a lower generation, thus limiting the ability to extend the life of grandfathered trusts.

Note that the regulatory safe harbors do not apply to zero inclusion ratio trusts. However, the IRS has extended the application of the safe harbors by analogy. These private letter rulings are not precedent but should be used as the guideline in determining that the same reasoning that applies to grandfathered trusts should also apply to zero inclusion ratio trusts.

Therefore, as long as the fact pattern of the decanting using the Delaware decanting statute falls within one of the safe harbors, we believe there should be no adverse GST tax implications for trusts sheltered by reason of being grandfathered, nor for trusts sheltered by allocation of the GST tax exemption.

**TOPIC 13: None of the changes described above are made, but a future power to make any such changes is created**

Nearly any administrative change could be made to the terms governing a trust if the trustee has the power pursuant to the Delaware decanting statute to appoint the principal of the trust in favor of the trustee of the Receiving Trust. In general, such administrative changes should have no tax implications. An illustration of an administrative decanting having no tax implications is one where the Receiving Trust has the same terms as the Distributing Trust except that the Receiving Trust provides for a separate direction advisor regarding investments. Whether the decanting is administrative or otherwise, decanting should be regarded as continuing the identity of the grantor of the Distributing Trust to the Receiving Trust.

However, there may be circumstances under which estate tax issues could arise in the course of changing the administrative provisions governing a trust through the exercise of a decanting power under the Delaware decanting statute. For example, if the terms governing the Receiving Trust provide that the current beneficiary may change the beneficiary of a life insurance policy on the beneficiary’s life owned by the trust, or may surrender or cancel the policy, and the beneficiary did not hold such powers

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over the Distributing Trust prior to the decanting, then the inclusion of such new powers in the instrument governing the Receiving Trust could cause the proceeds of the life insurance policy to be includible in the beneficiary’s estate. Pursuant to Code § 2042(2), insurance proceeds on a decedent’s life are includible in the estate of a decedent if the decedent possessed at his death any of the incidents of ownership of such policies, exercisable either alone or in conjunction with any other person. An insured could be deemed to hold “incidents of ownership” if (1) the insured has a reversionary interest that exceeds 5 percent of the value of the policy immediately before the insured’s death,26 (2) the insured has the power to change the beneficiary of the policy, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy,27 or (3) the insured has the power to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof.28 If any insured (and not merely a current trust beneficiary) is given such rights or powers in the instrument governing the Receiving Trust created by the trustee under circumstances where such rights or powers did not exist prior to the decanting, the decanting could cause estate tax issues to arise under Code § 2042(2). It would be possible for a trustee to grant powers and rights to persons other than beneficiaries by exercising its powers to decant the trust pursuant to the Delaware decanting statute, if beneficial interests are not directly affected. If a trustee were to grant powers and rights in favor of the grantor of the Distributing Trust by the exercise of its decanting power, estate tax issues could arise for the grantor. For federal estate tax purposes, the grantor of the Distributing Trust should continue to be viewed as the grantor of the Receiving Trust if one is created by decanting. As a general matter for purposes of federal tax law, whenever a Receiving Trust is created under or pursuant to a trust instrument created by a grantor, the grantor is viewed as the grantor of the Receiving Trust. This principle already exists in the Code with respect to federal income and generation-skipping transfer tax laws.29 We believe that the same principle should apply for federal estate tax purposes when identifying the grantor of a new Receiving Trust created pursuant to a trustee’s exercise of a power to decant. Assuming that, for federal estate tax purposes, the grantor of the Distributing Trust is deemed to be the grantor of a Receiving Trust created pursuant to the Delaware decanting statute, if the grantor is given a power under the instrument governing the Receiving Trust to alter, amend or revoke the Receiving Trust within the meaning of Code § 2038, the property of the Receiving Trust should be includible in the grantor’s estate for federal estate tax purposes.

On the other hand, the inclusion of a power described exclusively in Code § 2036 in the instrument governing a Receiving Trust created pursuant to the Delaware decanting statute should not, in and of itself, cause the trust property to be included in the estate of the grantor for federal estate tax purposes, if such power did not exist with respect to the Distributing Trust. In order for Code § 2036 to apply, the grantor would have had to “retain” the power in question from the time of the transfer of property to the Distributing Trust.

26 See I.R.C. § 2042(2); Treas. Reg. § 20.2042-1(c)(3).
29 See I.R.C. § 2652(a)(1) (“transferor”, for federal generation-skipping transfer tax purposes, means, (A) in the case of any property subject to the tax imposed by chapter 11, the decedent, and (B) in the case of any property subject to the tax imposed by chapter 12, the donor, except as otherwise provided in Section 2652(a)(1) or 2653(a) of the Code.); see also Treas. Reg. § 1.671-2(e)(5) (With respect to federal income tax, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.).
Concluding remarks

As there are several responses being submitted to IRS Notice 2011-101 that cover the topic of decanting thoroughly, we have applied our responses to the application of decanting under Delaware law. We welcome guidance from the Internal Revenue Service on the income, estate and gift, and GST tax implications of decanting. We hope this response is useful to the Service in providing that guidance.

Sincerely,

Delaware State Bar Association, Estates & Gifts Section

Kimberly M. Gill, Chair

[Signature]

Delaware Bankers Association

[Signature]

David G. Bakerian, President, CEO, and Treasurer
REQUEST FOR COMMENTS REGARDING THE INCOME, GIFT, ESTATE AND
GENERATION-SKIPPING TRANSFER TAX CONSEQUENCES
OF
TRUST DECANTING

April 26, 2012
TABLE OF CONTENTS

I. OVERVIEW OF TRUST DECANTING.................................................................1
   A. Definition of Decanting ..............................................................................1
   B. Purposes of Decanting ..............................................................................1
      1. Addressing Changed Circumstances.....................................................2
      2. Implementing Administrative Changes.................................................2
      3. Dividing and Combining Trusts............................................................3
      4. Modifying Tax Status...........................................................................3
   C. Authority ....................................................................................................3
      1. Common Law .......................................................................................3
      2. Statutory Authority..............................................................................5
         (a) Who May Exercise a Decanting Power ............................................5
         (b) Fiduciary Duties ............................................................................6
         (c) Authority to Invade Principal .......................................................6
         (d) Adding or Excluding Beneficiaries .................................................7
         (e) Preserving Fixed Income Rights and Withdrawal Powers ..........7
         (f) Preserving Other Tax Benefits ......................................................8
         (g) Extending the Term of the Trust ...................................................8
         (h) Granting Powers of Appointment ................................................9
         (i) Accelerating Interests ..................................................................10
         (j) Judicial Authorization and Beneficiary Consent .........................10
         (k) Notice Requirements ..................................................................10
   D. Existing Treasury Regulations Dealing With Trust Decanting .............11

II. SUMMARY OF RECOMMENDATIONS..............................................................11
   A. Income Tax .............................................................................................11
   B. Gift Tax ..................................................................................................12
   C. Estate Tax ..............................................................................................13
   D. Generation Skipping Transfer Tax ............................................................13

III. INCOME TAX ISSUES..................................................................................14
   A. Fiduciary Income Tax Consequences .....................................................15
      1. General Treatment as a Distribution .................................................15
      2. Exception for Substantially Similar Trusts ........................................15
      3. Succeeding to the Distributing Trust’s Tax Attributes ....................16
      4. Decanting a Foreign Trust in Favor of a Domestic Trust ...............16
B. Gain Recognition ...........................................................................................17
   1. Gain Recognition by Beneficiaries .....................................................17
   2. Gain Recognition by the Distributing Trust .....................................19
C. Identity of the Grantor ...................................................................................21
D. Adding Beneficiaries .....................................................................................22
E. Charitable Deduction .....................................................................................22
   1. Contributions to the Distributing Trust ..............................................22
   2. Distributions from the Receiving Trust Pursuant to a Power of Appointment ......................................................................................23
IV. GIFT TAX ISSUES ..................................................................................................23
A. Trustee as Beneficiary ...................................................................................24
B. Consent of Beneficiary ..................................................................................25
C. Granting a Power of Appointment ..................................................................26
D. Decanting to a Grantor Trust ..........................................................................27
E. The Delaware Tax Trap .................................................................................27
F. Gift Tax Deductions and Exclusions ..............................................................28
V. ESTATE TAX ISSUES .............................................................................................29
A. Grantor’s Involvement in Decanting ..............................................................29
B. Delaware Tax Trap ........................................................................................30
C. Charitable and Marital Deductions .................................................................30
VI. GENERATION-SKIPPING TRANSFER TAX ISSUES ...........................................31
A. Overview of Generation-Skipping Transfer Tax ...........................................31
   1. Generation-Skipping Transfers ...........................................................31
   2. Identifying the Transferor ...................................................................32
   3. Transfers by Non US Persons ..............................................................32
   4. GST Exemption .................................................................................32
   5. Inclusion Ratio ...................................................................................33
   6. Trusts Exempt from GST Tax .............................................................33
B. GST Tax Consequences of Decanting ............................................................34
   1. Trusts that Are Exposed to the GST Tax ..............................................34
   2. Grandfathered Trusts ..........................................................................35
      (a) Decanting Authorized When Trust Became Irrevocable ...............35
      (b) No Shift in Beneficial Interests .................................................35
   3. Exempt Trusts Due to Allocation of GST Exemption .........................36
   4. Trusts Created by NRAs .....................................................................37
5. Loss of GST Exempt Status ................................................................. 37
6. 2642(c) Trusts .................................................................................... 38

VII. CONCLUSION ............................................................................................. 38
New York State Bar Association Tax Section
New York State Bar Association Trusts and Estates Law Section

Report On Notice 2011-101

This report (the “Report”) responds to the request from the Office of Associate Chief Counsel, Passthroughs & Special Industries, in Notice 2011-101 (the “Notice”), for comments regarding the income, gift, estate, and generation-skip transfer (or GST) tax consequences arising when the trustee of one irrevocable trust transfers part or all of the trust principal to another irrevocable trust, frequently referred to as “decanting.”

As requested in the Notice, this Report specifically addresses the tax consequences where the decanting results in a change in the beneficial interests in the trust. In addition, we consider the specific circumstances identified in the Notice which may affect the tax analysis.

I. OVERVIEW OF TRUST DECANTING

A. Definition of Decanting

Decanting refers to the trustee’s payment of part or all of the principal of an irrevocable trust (the “Distributing Trust”) to another irrevocable trust (the “Receiving Trust”) for the benefit of one or more of the beneficiaries of the Distributing Trust. A trustee’s authority to decant may derive from the terms of the document governing the Distributing Trust (that is, the trust instrument or Will) or, as discussed below, applicable state law. Authority under state law, in turn, may derive from common law principles or a specific decanting statute.

B. Purposes of Decanting

Trust decanting may be employed by a trustee for numerous reasons to ensure that the grantor’s objectives are achieved, to protect the interests of the beneficiaries and/or preserve the trust assets. In addition, decanting can be used to correct drafting errors in an irrevocable instrument. In recent years, decanting has gained recognition as a potent strategy for trustees to

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1 The principal authors of this Report are Janet L. Blakeman, Gerald Carp, Jill Choate-Beier, Kathleen M. Citera, Alan S. Halperin, Amy E. Heller, Laurence Keiser, Joseph T. La Ferlita, Natalia Murphy, Andrea L. Sanft, Alex Segal and Susan P. Witkin. Helpful comments were received from Charles I. Kingson, Stephen B. Land and Michael L. Schler. The Report reflects solely the views of the Tax and Trust & Estates Law Sections of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.


3 The Notice indicates that there will be a “change in beneficial interest” when the interests of one or more of the beneficiaries are changed or terminated and/or when another beneficiary who did not have an interest in the Distributing Trust may receive an interest in Receiving Trust.

address a variety of issues and changed circumstances. Indeed, many practitioners include specific decanting authorization in the trust instrument to provide flexibility. In addition, many states recently have introduced or modified their decanting statutes to take into account the increased utility of trust decanting.

1. Addressing Changed Circumstances

Irrevocable trusts often provide for mandatory distributions of trust principal to a beneficiary at specified times, such as the beneficiary attaining a certain age. However, circumstances at that time may warrant retaining the assets in trust to address unanticipated changes, such as a beneficiary’s other available wealth or significant appreciation in the trust property. In addition, the trustee may wish to retain assets in trust if the beneficiary lacks the maturity necessary to handle the funds, has creditor problems, suffers from addiction or exhibits other negative behavior. A trustee also may wish to withhold distributions to a beneficiary so he or she may qualify for government or other public benefits. Decanting also has been relied on to provide or eliminate a trust’s spendthrift provisions, either to protect the trust’s assets from a beneficiary’s creditors, or conversely, to facilitate an assignment of the trust property. When used in this context, decanting may result in a change in beneficial interest.

Decanting further may provide a means to address changes in the law governing the administration or taxation of the trust.

2. Implementing Administrative Changes

A trustee may determine to decant in order to modify the administrative provisions of the trust, such as to provide for the succession, appointment or compensation of trustees or to expand or limit investment powers. A trustee also may decant in favor of another trust in order to change a trust’s governing law and to modify the trust instrument to conform to the new applicable law. Changes in administrative provisions are not likely to affect the beneficial interests of the beneficiaries.

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5 See, e.g., Matter of Riese, 164 Misc. 2d 1028, 627 N.Y.S. 2d 232 (Sur. Ct. New York County, 1995). In that case, the decanting extended the term of the trust to provide creditor protection for the beneficiary.

6 See, e.g., Estate of Grosjean, NYLJ December 10, 1997, p. 35, col. 6 (Sur. Ct. Nassau County), where a trustee was permitted to decant into a supplemental needs trust so that the beneficiary could qualify for government assistance.


8 See, e.g., Matter of Klingenstein, N.Y.L.J., 4/20/00, page 33, col. 6 (Sur. Ct. Westchester County) (decanting to modify the terms regarding trustees, including limitations on number of individual trustees, powers to remove and replace trustees, requirement for a corporate trustee and the designation of successor trustees).

9 See Matter of Riese, 164 Misc. 2d 1028 (the trustees of irrevocable trusts subject to New York law were permitted to pay the trusts’ assets to other trusts governed by Florida law).
3. **Dividing and Combining Trusts**

Decanting may enable a trustee to divide or segregate assets into separate trusts to address the different needs of each beneficiary, to employ different investment strategies or to facilitate tax planning. A trustee may decant assets from one trust to another to combine the assets and consolidate investments for ease of administration and to lower administrative costs.

4. **Modifying Tax Status**

Decanting may result in a change of the income tax status of the trust, from a grantor trust governed by Subpart E of Subchapter J of Chapter 1 the Code, to a complex trust, governed by Subparts B and C of Subchapter J. The opposite result also may occur: the Distributing Trust may be a complex trust, while the Receiving Trust may be a grantor trust. A trustee also may decant so that a trust may qualify as an S corporation shareholder.

C. **Authority**

1. **Common Law**

There are two possible bases, under common law principles, supporting the proposition that, under certain circumstances, a trustee has decanting power, even absent express authority granted in the governing trust instrument. One rationale is that a trustee with discretionary authority to make distributions of trust principal for the benefit of a trust beneficiary may exercise that authority by distributing trust principal in further trust for the benefit of that beneficiary.

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10 See, e.g., In re Estate of Scheuer, NYLJ July 10, 2000 (Sur. Ct. N.Y. County.) (the trustees distributed the trust property to separate trusts for each beneficiary so that each beneficiary’s trust could be managed separately, in accordance with the beneficiary’s financial needs and investment objectives).

11 For example, a trustee may wish to divide trust property into GST exempt and non-exempt shares if a trust has an inclusion ratio between zero and one. See IRC § 2642(a)(3) and Treas. Reg. § 26.2642-6, relating to qualified severances for GST tax purposes. In that case, the trustee may implement different investment and distribution strategies based on the anticipated estate or GST tax consequences for each trust.

12 See, e.g., Matter of Vetlesen, N.Y.L.J., 6/29/99, page 27, col. 3 (Sur. Ct., N.Y. County) (the trustee was permitted to combine two trusts and reduce trustee commissions).

13 Unless indicated otherwise, all “Section” references are to the Internal Revenue Code of 1986, as amended (the “Code”), and all “Treas. Reg. §” references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this Report.

14 See IRC §§ 671-679 and IRC §§ 652 and 662. See also CCA 200923024, (conversion of non-grantor trust to grantor trust not a transfer for income tax purposes).

15 See IRC § 1361(c)(2).

16 See Priv. Ltr. Rul. 200530012 (Mar. 24, 2005) (the facts of the Private Letter Ruling disclose that a state court confirmed that a trustee’s authority to distribute “to or for the benefit of” a beneficiary permitted a distribution to another trust for the same beneficiary).
The other rationale under common law is based, in part, on the theory that a trustee’s power to distribute principal is akin to a special power of appointment.\textsuperscript{17} It generally is accepted that a person holding a power of appointment may appoint to the fullest extent of the authority or to a lesser extent absent express prohibition in the trust instrument.\textsuperscript{18} In other words, if there is authority to make an outright distribution to a beneficiary, there is authority to distribute in further trust for the benefit of such beneficiary. Admittedly, a trustee’s distribution power is distinguishable from a traditional power of appointment: Powers of appointment generally are not subject to fiduciary duties, while the trustee’s discretionary power to distribute is subject to fiduciary duties.\textsuperscript{19} Nevertheless, the same rationale – a power that may be exercised to the fullest extent (outright) also may be exercised to a lesser degree (in further trust) – has been cited in support of the common law right to decant.\textsuperscript{20}

Two reported cases have applied these principles in a fashion to support a trust decanting absent statutory authority. In \textit{Phipps v. Palm Beach Trust Company},\textsuperscript{21} the trustee had sole discretion to sprinkle income and principal among the donor’s descendants. The trustee exercised the power by distributing the trust property to a new trust. The Supreme Court of Florida approved the distribution, stating that “[a]n examination of the trust indenture in this case leaves no doubt of the power of the individual trustee to create the second trust provided one or more of the descendants of the donor of the original trust are made the beneficiaries.”\textsuperscript{22} In reaching this conclusion, the Florida Supreme Court relied on case law and the general rule that a “power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee, unless the donor clearly indicates a contrary intent.”\textsuperscript{23}

In \textit{Wiedenmayer v. Johnson},\textsuperscript{24} the trustees of a trust for the settlor’s son were directed “from time to time and whenever in their absolute and uncontrolled discretion they deem it to be for his best interests, to use for or to distribute and pay over to [the son] . . . to be his absolutely, outright and forever, any or all of the Trust Property.”\textsuperscript{25} The New Jersey court concluded that the trustees’ “absolute and uncontrolled discretion” to distribute the Trust

\textsuperscript{17} \textsc{Restatement (Second) of Property: Donative Transfers} § 11.1 cmt. d (1986).

\textsuperscript{18} \textsc{See}, e.g., In re Hart’s Will, 262 A.D. 190, 28 N.Y.S.2d 781 (1941), In re Nicholas’ Will, 284 A.D. 971, 134 N.Y.2d 809 (1954), aff’d 308 N.Y. 971, 127 N.E.2d 337 (1955); In re Reynal’s Will, 58 Misc.2d 518, 296 N.Y.S.2d 158 (Sur.Ct.1968); In Re: the Trust for the Benefit of Elaine Johnson Wold 310 N.J. Super. 382, 708 A.2d 787 (1998).

\textsuperscript{19} \textsc{Restatement (Third) of Trusts}, § 50 (“A trustee’s discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power”). \textsc{See also} \textsc{Restatement (Third) of Trusts} §§ 64 and 75.

\textsuperscript{20} \textsc{See generally} William R. Culp, Jr. & Briani Bennett Mellen, \textit{Trust Decanting: An Overview and Introduction to Creative Planning Opportunities}, 45 REAL PROP. TR. & EST. L. J. 1, 46 (2010); Halperin and O’Donnell \textit{supra} note 4 at §§ 1302.2.

\textsuperscript{21} 142 Fla. 782 (1940).

\textsuperscript{22} \textit{Id.} at 786.

\textsuperscript{23} \textit{Id.} at 786.


\textsuperscript{25} \textit{Id.} at 535.
Property to the son was limited solely by the trustees’ determination that such distribution was for the son’s “best interests.” Accordingly, in the face of opposition from the remaindermen of the son’s original trust, the court stated: “If [the trustees] could make [a distribution for the son’s best interests] to the end, as the trust indenture expressly stated, that the trust property would be the son’s ‘absolutely, outright and forever,’ it seems logical to conclude that the trustees could, to safeguard the son’s best interests, condition the distribution upon his setting up a substituted trust.”

2. **Statutory Authority**

Fifteen states have enacted decanting statutes. They are Alaska, Arizona, Delaware, Florida, Indiana, Kentucky, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, South Dakota, Tennessee and Virginia. In addition, in just the past few months, several other states have introduced decanting legislation, including Colorado, Illinois, Michigan and Rhode Island.

While the state statutes vary, they have common elements. The statutory provisions that may have relevance to the tax consequences of decanting are set forth below.

(a) **Who May Exercise a Decanting Power**

Each decanting statute specifies that the authority to decant is exercisable only by a trustee who has the authority to invade principal for the benefit of a trust beneficiary. Certain states limit which trustees may exercise the decanting power. For example, under New York law, only an “authorized trustee” may exercise the power to decant. An authorized trustee is any trustee other than the grantor and any beneficiary to whom income or principal must be paid currently or in the future, or who is or will become eligible to receive a distribution of income or principal in the discretion of the trustee (other than by the exercise of a power of appointment held by another in a non-fiduciary capacity). Most state decanting statutes further prohibit a trustee from exercising the decanting power in a fashion that would give rise to a general power of appointment.

Under the South Dakota statute, restrictions also are placed on the ability to decant held by any trustee who is a beneficiary of the Distributing Trust or who has a power to

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26 Id. at 535-36.

27 Id. at 536.

28 Virginia’s decanting legislation was passed by the state senate on January 19, 2012 and signed into law by the Governor on April 4, 2012. See Prop. § 55-548.16:1 CODE OF VA SB 110. The Kentucky legislation was signed into law on April 11, 2012. See Prop. § 386. KRS; HB 155.

29 See AK STAT. § 13.36.157(a); A.R.S. § 14-10819; 12 DEL. C. § 3528(a); FLA. STAT. § 736.04117(1)(a); IC § 30-4-3-36; MO REV. STAT. § 456.4-419(1).

30 See, e.g., N.Y. EPTL (“EPTL”) § 10-6.6(1)(a).

31 See, e.g., AK STAT. § 13.36.157(c); A.R.S. § 14-10819(C); 12 DEL. C. § 3528(c); EPTL § 10-6.6(2); FLA. STAT. § 736.04117(3); IC § 30-4-3-36(d); MO REV. STAT. § 456.4-419(2)(a); N.C. GEN. STAT. § 36C-8-816.1(d); NEV. REV. STAT. § 163.556(3); NH REV. STAT. § 564-B:4-418(c); O.R.C. § 5808.18(E); S.D. CODIFIED LAWS § 55-2-15(2)(a). See also IRC §§ 2041 and 2518 (regarding general powers of appointment).
change the Trustees. Similarly, Missouri law prohibits the following trustees from participating in a decanting: any trustee who is a beneficiary or who may remove any other trustee and designate as a successor trustee a person who is related or subordinate to him or her, within the meaning of Section 672(c).

(b) Fiduciary Duties

While all decanting powers are exercised by trustees, and therefore are presumably subject to fiduciary duties, some states expressly set forth a standard of care governing the trustee’s exercise of the decanting power. The New York statute, for example, provides that the trustee has a “fiduciary duty to exercise the power in the best interests of one or more proper objects of the exercise of the power and as a prudent person would exercise the power under the prevailing circumstances.” Additionally, Ohio provides that a trustee “who acts reasonably and in good faith in exercising [the decanting power] is presumed to have acted in accordance with the terms and purposes of the [Distributing Trust] and the interests of the beneficiaries.”

(c) Authority to Invade Principal

Under all decanting statutes, in order to decant, the trustee must have discretion to invade principal in favor of one or more of the trust beneficiaries. Certain states permit decanting only if the trustee has unlimited authority to invade principal. Alaska, Delaware and Tennessee permit a trustee to decant even if the principal invasion power is limited by a standard. Similarly, under the New York statute, a trustee with unlimited discretion to invade principal can decant in favor of one, more than one or all of the trust beneficiaries and may exclude one or more beneficiaries. A trustee who does not have unlimited discretion also may decant, so long as the Receiving Trust has the same beneficiaries and the same restrictions on distributions.

33 MO REV. STAT. § 456.4-419(2).
34 See, e.g., EPTL § 10-6.6(h); 12 DEL. C. § 3528(e).
35 EPTL § 10-6.6(h).
36 O.R.C. § 5808.18(I).
37 See, e.g., FLA. STAT § 736.04117(1)(a). Under the Florida statute, a power to invade principal for the “best interests, welfare, comfort or happiness” of a beneficiary qualifies as an “absolute power,” so long as it is not limited to specific or ascertainable purposes.
38 See AK STAT. § 13.36.157; 12 DEL. C. § 3528; TENN. CODE ANN. § 35-15-816(b)(27). Under Delaware’s decanting statute, the trustee’s exercise of the decanting power must conform with any standard imposed by the Distributing Trust. 12 DEL. C. § 3528(a)(5).
39 EPTL § 10-6.6(b) and (c). For purposes of the statute, the term “unlimited discretion” means the authority to distribute principal that is not modified in any way. Terms directing that distributions be made for the beneficiary’s best interests, welfare, comfort or happiness are not considered modifications on the trustee’s authority to distribute principal.
40 If the Receiving Trust extends the term of the trust beyond the term of the Distributing Trust, the Receiving Trust may grant the trustee unlimited discretion to invade principal during the extended period of the term. EPTL § 10-6.6(c)(2).
South Dakota law permits a trustee to decant income or principal in favor of one or more of the trust beneficiaries. While the trustee may decant even if the trustee’s discretion to pay income and/or principal is limited to a standard, the trustee must take into account various factors, including: whether the appointment is necessary or desirable after taking into account the purposes of the Distributing Trust, the terms and conditions of the Receiving Trust, and the consequences of the distribution.

(d) Adding or Excluding Beneficiaries

All of the state statutes require that the authority to decant be exercised in favor of one or more of the beneficiaries of the Distributing Trust. As a result, in no event may a trustee decant in favor of a person who is not a beneficiary of the Distributing Trust. The New York statute specifies that a trustee with unlimited power to invade principal may exclude one or more beneficiaries of the Distributing Trust and although other statutes do not refer specifically to exclusion, the ability to decant in favor of one or more (but not all) of the permissible beneficiaries necessarily includes a power to exclude.

(e) Preserving Fixed Income Rights and Withdrawal Powers

New York, Alaska, Arizona, Florida, Indiana, Nevada and Tennessee do not permit a trustee to reduce a beneficiary’s fixed income interest in the Distributing Trust. The Delaware, Missouri, and South Dakota statutes provide similar protection but only in the case of certain trusts, such as a trust for which a marital deduction had been taken for federal estate or gift tax purposes, a charitable remainder trust or a grantor retained annuity trust.

Certain states such as Delaware, Nevada, New York, North Carolina and South Dakota have specific provisions that address a beneficiary’s withdrawal power over the Distributing Trust. Under Delaware, Nevada and South Dakota law, a decanting may eliminate a beneficiary’s right of withdrawal over trust property as long as the right of withdrawal is not presently exercisable. North Carolina law, however, provides that if a beneficiary has a power of withdrawal over trust property in the Distributing Trust, the terms of the Receiving Trust must provide the beneficiary with an identical right of withdrawal.

41 S.D. CODIFIED LAWS § 55-2-15.
42 Id.
43 A trustee’s ability to decant in favor of a trust that grants a beneficiary a power of appointment does not constitute a power to add beneficiaries. See infra, Section I(C)(2)(h) of this Report.
44 EPTL § 10-6.6(b).
45 AK STAT. § 13.36.157(a)(1); A.R.S. § 14-10819(A)(1); EPTL § 10-6.6(n)(1); FLA. STAT. § 736.04117(1)(a)(2); IC § 30-4-3-36; NEV. REV. STAT. 163.556; TENN. CODE ANN. § 35-15-816(b)(27)(a).
46 12 DEL. C. § 3528(3); MO REV. STAT. § 456.4-419(1); S.D. CODIFIED LAWS § 55-2-15(6). See IRC §§ 2056, 2523, 664 and 2702.
47 See, e.g., 12 DEL. C. § 3528(a)(4).
48 N.C. GEN. STAT. § 36C-8-816.1.
(f) Preserving Other Tax Benefits

Many state statutes prohibit the exercise of the decanting power in a manner that will jeopardize tax benefits inherent in the Distributing Trust. For example, the Arizona statute contains a broad limitation. Under Arizona law, the decanting power may not be exercised if the decanting adversely affects the tax treatment of the trust, the trustee, the settlor or the beneficiaries. Other state statutes are more specific. For example, under the Florida statute, a decanting power may be exercised with respect to a Distributing Trust that qualified for the marital or charitable deduction for federal tax purposes only if the Receiving Trust does not contain any provision that would have prevented the Distributing Trust from qualifying for such deduction or would have reduced such deduction if such provision were included in the Distributing Trust.

In addition, many of the state decanting statutes require that, if contributions to the Distributing Trust qualified for the annual gift tax exclusion under Section 2503(b) based on the trust’s qualification under Section 2503(c), the Receiving Trust must provide that the beneficiary’s remainder interest in the trust must vest no later than the date upon which such interest would have vested under the terms of the Distributing Trust.

Some state statutes have similar savings language to preserve the tax status of the Distributing Trust as a qualified S corporation shareholder under Section 1361, and the qualification of a transfer as a direct skip under Section 2642(c).

(g) Extending the Term of the Trust

Some state statutes expressly authorize extending the trust term by decanting. In most cases, the exercise of the decanting power may not violate the rule against perpetuities as measured by reference to the Distributing Trust. Although decanting in a manner that extends the trust term may be prohibited, decanting from a perpetual Distributing Trust to a perpetual Receiving Trust is permitted, so long as the law governing the Receiving Trust authorizes perpetual trusts.

49 A.R.S. § 14-10819(A)(5).
50 Id.
51 FLA. STAT. § 736.04117(1)(a)(3). Similar provisions exist under the decanting statutes in Delaware, Indiana, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio and South Dakota. See 12 DEL. C. § 3528(3); EPTL § 10-6.6(n)(5); IC § 30-4-3-36(a)(3); MO REV. STAT. § 456.4-419.2(5); NEV. REV. STAT. 163.556(2)(c); NH Rev. Stat.§ 564-B:4-418(b)(3); N.C. GEN. STAT. § 36C-8-816.1(c)(4); O.R.C. § 5808.18(C)(2); S.D. CODIFIED LAWS § 55-2-15(6)(a).
52 See, e.g., 12 DEL. C. § 3528(a)(2); MO REV. STAT. § 456.4-419.2(4); NEV. REV. STAT. 163.556(2)(h).
53 See, e.g., O.R.C. § 5808.18(C)(4);
54 See, e.g., EPTL § 10-6.6(n)(5).
55 See, e.g., EPTL § 10-6.6(e).
56 See, e.g., AK STAT. 13.36.157(a)(3); FLA. STAT. § 736.04117(1)(b)(3); N.C. GEN. STAT. § 36C-8-816.1(e)(2).
(h)  Granting Powers of Appointment

Absent a prohibition under state law or the governing instrument of the Distributing Trust, a trustee with decanting authority generally may decant in favor of a Receiving Trust that grants a beneficiary a power of appointment, whether presently exercisable or in the future, and regardless of whether such a power existed in the Distributing Trust. In addition, the class of appointees in the Receiving Trust may extend beyond the class of permissible beneficiaries of the Distributing Trust. Since the decanting power itself is treated as a power of appointment under state statutory law (and under analogous common law principles), the same rules applicable to powers of appointment provide a framework for the legal analysis.

The donee of a power of appointment may exercise the power only within the permitted scope and may not exercise the power in favor of someone who is not within the class of permissible appointees. For example, the power to appoint among the grantor’s descendants does not authorize appointment in trust for the life of a child, with the remainder to charity, because charity is not included in the permissible class of appointees. Nevertheless, since a donee of a power of appointment may appoint the trust property outright to a beneficiary (who is within the permissible class), the donee also may exercise the power of appointment in a more limited fashion. For example, if the power is limited in favor of the grantor’s descendants, the donee of the power of appointment may appoint in further trust for the life of a child, while granting the child with a testamentary power of appointment exercisable in favor of descendants and charity. The reason is that, if the donee could have appointed the property outright in favor of the child, the child could be given rights that fall short of outright ownership.

In light of the foregoing, if the trustee has broad discretion to distribute outright to a beneficiary, such trustee should have the authority to decant in favor of a trust for the beneficiary, while granting that beneficiary a power of appointment (even if the class of permissible appointees extends beyond the beneficiaries of the Distributing Trust). To be clear, the decanting (with the grant of a power of appointment) is not the equivalent of expanding the class of beneficiaries of the Distributing Trust. Rather it is consistent with the exercise of the decanting power in favor of the beneficiary (who is granted the power of appointment).

Several statutes recognize this principle. New York’s statute distinguishes between the scope of the power of appointment which may be granted by a trustee of a Distributing Trust who has unlimited discretion to invade trust principal, and a trustee who has limited discretion. A trustee with unlimited discretion may grant either (i) a broad power of appointment in favor of a virtually unlimited class of appointees, which may exclude as permissible appointees one or more of the beneficiary, the grantor, the grantor’s spouse, or the estates, creditors or creditors of the estates of the beneficiary, grantor or grantor’s spouse or (ii) a power of appointment identical to any power of appointment held by the beneficiary under the

57 See In re Fiske, 88 N.Y.S. 2d 446 (Sur. Ct. N.Y. County 1949); Halperin and O'Donnell, supra note 4, at ¶ 1303.1.
59 See EPTL § 10-6.6(b)(1); N.C. GEN. STAT. § 36C-8-16.1(c)(8); NEV. REV. STAT. § 163.556.5; 12 DEL. C. § 3528(a); O.R.C. § 5808.28(A)(3)(a).
Distributing Trust. In the case of a decanting by a trustee with limited discretion, if a beneficiary holds a power of appointment under the Distributing Trust, an identical power of appointment must be provided for the beneficiary under the Receiving Trust.

(i) Accelerating Interests

State statutes generally prohibit against the acceleration of remainder interests as a result of decanting. The South Dakota statute, in contrast, authorizes a trustee to exercise the decanting power in favor of one or more beneficiaries of the Distributing Trust “to or for whom a distribution of income or principal may be made in the future from the [Distributing Trust] or at a time or upon the happening of an event specified under the [Distributing Trust].” Therefore, the trustee presumably may include a beneficiary with no current beneficial interest in the Distributing Trust as a current beneficiary of the Receiving Trust. Accelerating the interests of a future beneficiary would constitute a shift in the trust’s beneficial interests.

(j) Judicial Authorization and Beneficiary Consent

Some states such as Arizona, Nevada, New York and North Carolina permit, but do not require, a trustee to seek judicial approval for a decanting. With one exception, no decanting statute requires prior court or beneficiary consent. The one exception is Nevada, which requires a trustee to secure a beneficiary’s consent in circumstances where the trustee eliminates or limits a beneficiary’s interest in the Distributing Trust.

(k) Notice Requirements

New York, Florida, Indiana, Missouri, North Carolina and Ohio require that notice of the decanting be given to the persons interested in the trust. The New York and Ohio statutes require that the interested parties be given 30 days’ notice, while Florida, Indiana, Missouri and North Carolina require 60 days’ notice. The notice period gives beneficiaries an opportunity to object to the trustee’s exercise of its power to decant.

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60 See EPTL § 10-6.6(b)(2) and (3).
61 See EPTL § 10-6.6(c)(4).
62 See N.C. GEN. STAT. § 36C-8-816.1(c)(2). See also DEL. C. § 3528(a)(1); EPTL § 10-6.6(h); TENN. CODE ANN. § 35-15-816(b)(27)(a).
63 S.D. CODIFIED LAWS § 55-2-15(1).
64 If the grantor is living, the power to accelerate an individual’s beneficial interest may render the trust a grantor trust for income tax purposes. See IRC § 674.
65 A.R.S. 1.10819(D); NEV. REV. STAT. § 163.556(4) (2009); EPTL § 10-6.6(j)(1); N.C. GEN. STAT. § 36C-8-816.1(b).
66 NEV. REV. STAT. § 163.556(2)(c).
67 EPTL § 10-6.6(j)(2); O.R.C. § 5808.18(F).
68 FLA. STAT. § 736.04117(1)(b)(4); IC § 30-4-3-36 (e); MO REV. STAT. § 456.4-419(3); N.C. GEN. STAT. § 36C-8-816.1(f)(2).
New York also requires notice be given to the grantor of the Distributing Trust and any person with the right to remove or replace the trustee of the Distributing Trust.\textsuperscript{69}

D. Existing Treasury Regulations Dealing With Trust Decanting

Existing regulations and Code provisions, in limited instances, deal expressly with decanting. For example, the GST regulations provide that, under certain circumstances (discussed in greater detail below), the distribution of trust principal “from an exempt trust to a new trust or retention of trust principal in a continuing trust” will not cause the new or continuing trust to be subject to the provisions of chapter 13.\textsuperscript{70} Section 2653(b), which provides the rule for determining the inclusion ratio of property transferred in trust, includes a special rule for transfers from one trust to another trust (referred to therein as the “pour over trust”).\textsuperscript{71}

Another example is found in the Treasury Regulations under Section 671, with respect to the identity of the grantor of a trust for income tax purposes. Under that regulation, if a trust makes a transfer to another trust, the grantor of the first trust generally will be treated as the grantor of the Receiving Trust.\textsuperscript{72}

II. SUMMARY OF RECOMMENDATIONS

Given the increasing authority to decant, both in trust documents and under state statutes, we offer this Report to suggest a comprehensive, consistent analysis of the tax consequences. While the focus of our analysis (as requested by the Notice) is on situations where the beneficial interests in the Distributing and Receiving Trusts are different, we also address situations where the beneficial interests remain the same. This Section of the Report summarizes our recommendations.

A. Income Tax

Regardless of whether a trust decanting is considered an exercise of a power of appointment in a fiduciary capacity or a form of a trust distribution, we recommend that the Internal Revenue Service (the “Service”) confirm that the general rules of Subchapter J apply when a trustee decants assets from a Distributing Trust to a Receiving Trust. We further recommend that, consistent with existing private letter rulings, the Service confirm that, when the Distributing and Receiving Trusts have substantially similar terms and the Receiving Trust receives all of the Distributing Trust assets, the Receiving Trust should be considered a continuation of the Distributing Trust for income tax purposes. In such a case, the trust decanting should be considered a non-event for income tax purposes; accordingly, the distribution to the Receiving Trust should not carry out distributable net income (or undistributed net income if the Distributing Trust is a foreign trust); nor should it lead to a recognition event if the distribution involves encumbered property with debt in excess of basis (or a partnership interest with a

\textsuperscript{69} EPTL § 10-6.6(j)(2).


\textsuperscript{71} IRC § 2653(b)(2).

\textsuperscript{72} Treas. Reg. § 1.671-2(e)(5).
negative capital account). We recommend that the Service confirm in such cases that the Receiving Trust may continue to use the taxpayer identification number of the Distributing Trust. We further recommend that the Service confirm that, even where the Distributing and Receiving Trusts are not substantially similar, all of the tax attributes of the Distributing Trust carry over to the Receiving Trust if the Distributing Trust decants all of its assets.

Additionally, we recommend that the Service confirm that, so long as the trust decanting is permitted under the governing document or applicable law, the beneficiaries do not recognize gain upon a trust decanting, except in the specific case where (i) the beneficial interests in the Distributing and Receiving Trusts vary materially and (ii) the beneficiaries must consent to the decanting under the trust agreement or applicable law. We also recommend that the Service confirm that, as a general matter, the Distributing Trust does not recognize gain or loss upon a distribution to a Receiving Trust.

One exception may involve a distribution of encumbered property with debt in excess of basis or a partnership interest with a negative capital account (other than a distribution from one grantor trust to another grantor trust deemed wholly owned by the same grantor). We recommend that the same principles that apply to outright distributions apply to distributions in further trust. Accordingly, gain recognition upon the distribution of such property should depend on whether *Crane v. Comm’r* and its progeny override Section 643(e); given the uncertainty on this question, if the Service concludes that gain should be recognized, we recommend that the rule apply only on a prospective basis. In any event, no gain should arise on a transfer from a Distributing Trust to a Receiving Trust that qualifies as a continuation of the Distributing Trust for income tax purposes.

Further, consistent with Treas. Reg. § 1.671-2(e)(5), we recommend that forthcoming guidance from the Service confirm that, for income tax purposes, the grantor of a Distributing Trust should be considered the grantor of the Receiving Trust.

Finally, we recommend that the Service confirm that neither the authority to decant nor the exercise of the decanting power will jeopardize the income tax charitable deduction that otherwise would be available to the grantor of the Distributing Trust so long as the decanting cannot defeat the rights of the charitable beneficiary in the Distributing Trust that give rise to the charitable deduction. In addition, the Service should confirm that, for purposes of the charitable deduction under Section 642(c), payments made from a Receiving Trust to charity upon a beneficiary’s exercise of a power of appointment shall be deemed to be “pursuant to the terms of the governing instrument,” so long as the granting of the power of appointment is valid under applicable law, even if no such power of appointment existed in the Distributing Trust.

B. Gift Tax

We recommend that, where the trustee of the Distributing Trust has no beneficial interest in the Distributing Trust, or the beneficial interests are limited to an ascertainable standard, a trust decanting should not give rise to a taxable gift, even where there is a shift of a beneficial interest.
We further recommend that, unless the beneficiary also is a trustee participating in the decanting decision or such beneficiary’s consent is required for a decanting which reduces his or her beneficial interest, the beneficiary will not be deemed to have made a taxable gift when the trustee exercises the power to decant trust assets.

We also recommend that the Service confirm that there is no taxable gift upon a decanting from a Distributing Trust that is a non-grantor trust for income tax purposes to a Receiving Trust that is a grantor trust. The Service should also confirm that the provisions of Section 2514(d) do not apply to the exercise of a trustee’s decanting power so long as the trustee has no beneficial interest in the Distributing Trust.

Finally, we recommend that the Service confirm that neither the authority to decant nor the exercise of the decanting power will jeopardize any marital deduction, charitable deduction or annual exclusion that is otherwise available to the grantor of the Distributing Trust for gift tax purposes so long as the decanting cannot defeat the rights of the relevant beneficiaries in the Distributing Trust that give rise to such deduction or exclusion.

C. Estate Tax

We recommend that the Service confirm that, unless the grantor has retained the power to participate in the exercise of the decanting power, the trustee’s exercise of a trust decanting power does not cause estate tax inclusion with respect to the grantor. We further recommend confirmation that the provisions of Section 2041(a)(3) do not apply to the trustee’s exercise of a decanting power.

Finally, we recommend that the Service confirm that neither the authority to decant nor the exercise of the decanting power will jeopardize the marital deduction or charitable deduction available for estate tax purposes with respect to the assets of the Distributing Trust so long as the decanting cannot defeat the rights of the relevant beneficiaries that give rise to such deduction.

D. Generation Skipping Transfer Tax

We recommend that, for GST tax purposes, in the case of a decanting of the entire trust, the tax attributes of the Receiving Trust flow from the Distributing Trust. Accordingly, we recommend that the Service confirm that, in identifying the transferor of the Receiving Trust in order to determine whether a GST event has occurred, the person who is the transferor of the Distributing Trust for GST tax purposes also be considered the transferor of the property transferred to the Receiving Trust, unless the decanting triggers a gift or estate tax. Where less than the entire Distributing Trust is decanted, no GST tax should be triggered with respect to any property that remains in the Distributing Trust by virtue of the decanting alone.

We further recommend that the Service confirm that the conversion of a Grandfathered Trust that is a complex trust (for income tax purposes) to a grantor trust does not taint GST exempt status.

We also recommend that Service clarify that the two safe harbors rules applicable to decanting Grandfathered Trusts apply, with certain modifications, to a trust that is exempt
from GST tax as a result of an allocation of GST exemption. With respect to the first safe harbor, we recommend that a modification of a trust to which the transferor’s GST exemption was allocated should not taint GST exempt status if (1) either (i) authority exists under the trust instrument permitting a trustee to appoint in further trust without the consent or approval of any beneficiary or court, or (ii) applicable state law permits such a distribution, irrespective of whether the law so permitted at the time that the Distributing Trust became irrevocable; and (2) the terms of the Receiving Trust do not extend the time for vesting of any beneficial interest in the trust beyond 21 years plus lives in being at the date the Distributing Trust became irrevocable. If the Distributing Trust has a term that may extend beyond the common law rule against perpetuities, a decanting to a Receiving Trust with a term that may also extend beyond the common law perpetuities period will also not taint GST exempt status because the term applicable to the assets received from the Distributing Trust will not have been extended.

The Service’s guidance further should confirm that with respect to a trust to which the GST tax does not apply because it was created by an individual who is neither a US citizen nor resident and funded in a fashion which was not subject to US estate or gift tax, a decanting should not affect the exempt status, even if the perpetuities period is extended or there are other changes in beneficial interests.

We further request that the Service issue guidance concerning the future application of the GST tax with respect to an exempt trust that loses its exempt status as a result of a decanting. In this regard, we recommend that the taint result in an inclusion ratio of one for the trust and that the GST tax consequences be applied prospectively. For purposes of ascertaining the identity of the transferor (to determine whether future GST events occur), the rules under Chapter 13 should be applied to the trust from inception.

Finally, we recommend that the Service confirm that a decanting will not jeopardize the zero inclusion ratio of a Distributing Trust that qualifies under Section 2642(c), so long as the decanting cannot defeat those rights of the Distributing Trust’s beneficiary that are necessary for the Distributing Trust’s qualification for a zero inclusion ratio under Section 2642(c).

III. INCOME TAX ISSUES

The exercise of a power by a trustee to distribute assets from a Distributing Trust to a Receiving Trust raises several income tax questions.\(^73\) The questions concern the fiduciary income tax consequences of such a distribution, the potential gain recognition by the beneficiaries of the Distributing Trust or by the Distributing Trust itself, and the identity of the grantor following the distribution. Trust decanting also raises questions relevant to the charitable deduction rules for both individuals and trusts.

\(^73\) Similar income tax questions may arise if a beneficiary exercises a power to appoint assets from a Distributing Trust to a Receiving Trust in a non-fiduciary capacity.
A. **Fiduciary Income Tax Consequences**

1. **General Treatment as a Distribution**

   Under the rules of Subchapter J of Chapter 1 of the Code, a distribution from a complex trust generally will carry out a share of the trust’s distributable net income, or DNI, to the beneficiary to whom the distribution is made.\(^{74}\) The beneficiary, in turn, generally will be required to include in gross income an amount equal to the share of the DNI carried out from the trust.\(^{75}\) If the trust making the distribution is a foreign trust, the distribution also may carry out a share of the trust’s undistributed net income, or UNI, which will be includible by the beneficiary, subject to an interest charge.\(^{76}\)

   There does not appear to be any express authority that specifically provides that the rules of Subchapter J apply to a decanting distribution from a Distributing Trust to a Receiving Trust. However, the Treasury Regulations and case law indicate that a trust can be a beneficiary of another trust, with the rules of Subchapter J applicable to a distribution to the beneficiary trust.\(^{77}\) As a general rule, we believe that it is appropriate for the rules of Subchapter J to apply to a decanting distribution from one trust to another trust.\(^{78}\) This result is appropriate, in our view, whether the trust decanting is viewed as an exercise of a power of appointment (in a fiduciary capacity) or a trust distribution.

2. **Exception for Substantially Similar Trusts**

   An exception to this general rule, however, may be appropriate in a situation where all of the assets of a Distributing Trust are distributed to a Receiving Trust having substantially similar terms. In our view, the Distributing and Receiving Trusts should be deemed to have substantially similar terms if the trusts have the same beneficiaries, standards for distributions and timing for payments. In such a case, it is reasonable to view the Receiving Trust as a continuation of the Distributing Trust. Accordingly, the distribution to the Receiving Trust should not carry out DNI (or UNI if the Distributing Trust is a foreign trust) but rather

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\(^{74}\) IRC § 661.  
\(^{75}\) IRC § 662.  
\(^{76}\) IRC §§ 665-668.  
\(^{77}\) See Treas. Reg. § 1.643(c)-1, which provides that for purposes of Part I of Subchapter J (which includes the fiduciary income tax rules described above), a beneficiary includes an heir, legatee or devisee (including an estate or trust) (emphasis added). See also Duke v. Comm’r, 38 BTA 1264, 1269 (1938); Comm’r v. Bishop Trust Co., 136 F2d 390 (9th Cir. 1943), aff’d 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).  
\(^{78}\) In contrast, if a trust is divided pursuant to the terms of a trust agreement or applicable state law, DNI will not be carried out pursuant to the rules of Subchapter J. Rather, each trust resulting from the division will receive a pro rata portion of the original trust’s DNI.
should be treated as a non-event for income tax purposes. This result is consistent with the conclusion reached by the Service in Private Letter Ruling 200607015 (February 17, 2006).

We further believe that the foregoing treatment of the Receiving Trust as a continuation of the Distributing Trust should apply whether the decanting involves all of the assets of the Distributing Trust or all of the assets other than any assets distributed to a beneficiary of the Distributing Trust contemporaneously with the decanting.

Further, in this limited circumstance, the Receiving Trust should be permitted to use the taxpayer identification number of the Distributing Trust.

3. Succeeding to the Distributing Trust’s Tax Attributes

If all of the assets of a Distributing Trust are distributed to one or more Receiving Trusts, there also is a question as to whether the Receiving Trust or Trusts should succeed to the Distributing Trust’s tax attributes, such as its net operating loss carryovers, its capital loss carryovers and its foreign tax credit carryovers. The Code specifically provides that on the termination of a trust, any unused net operating loss carryovers and capital loss carryovers pass out to the trust’s beneficiaries. There does not appear to be any specific authority addressing the transfer of other tax attributes to beneficiaries upon the termination of a trust. At a minimum, in the case of a decanting treated as a continuation of the Distributing Trust, the Receiving Trust should succeed to all of the Distributing Trust’s tax attributes. We further believe that a Receiving Trust should succeed to the tax attributes of a Distributing Trust even if the terms of the trusts are not substantially similar.

4. Decanting a Foreign Trust in Favor of a Domestic Trust

Under Subchapter J, a distribution from a foreign trust to a US person of accumulated income generally will carry out the foreign trust’s UNI, including an additional interest charge for the deemed period of the accumulation. In addition, accumulated capital

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79 We believe the same result — a non-event for income tax purposes — would follow when encumbered property with debt in excess of basis (or a partnership interest with a negative capital account) is distributed from one trust to another trust in which the substantive provisions remain the same.

80 See also Priv. Ltr. Rul. 200723014 (June 8, 2007) and Priv. Ltr. Rul. 200527007 (July 8, 2005).

81 In such a case, the distribution to the beneficiary will carry out all of the Distributing Trust’s DNI (limited to the amount of the distribution). By comparison, if the decanting also were treated as a distribution, each of the beneficiary and the Receiving Trust would receive a pro-rata share of Distributing Trust’s DNI. Our recommendation is consistent with the tax treatment of a complete decanting, followed by a distribution to the beneficiary.

82 IRC § 642(h); Treas. Reg. § 1.642(h)-3(d).

83 We believe that a Receiving Trust should succeed to the tax attributes of a Distributing Trust even if the terms of the trusts are not substantially similar. This result is consistent with other areas of the tax law. For example, if a private foundation transfers all of its assets to one or more private foundations that are effectively controlled by the same persons that control the transferor private foundation, the transferee private foundation is treated as if it were the transferor for purposes of Chapter 42 of the Code. See Treas. Reg. § 1.507-3(a)(9).
gains are recharacterized as ordinary income.\textsuperscript{84} These rules are commonly referred to as the “throwback rules.”\textsuperscript{85} The throwback rules generally should apply to a decanting from a foreign Distributing Trust to a domestic Receiving Trust under the general premise that a decanting should be treated as a trust distribution. We recommend that an exception should apply in the case of a decanting treated as a continuation of the foreign Distributing Trust.\textsuperscript{86} Under those circumstances, for the reasons discussed earlier, the Receiving Trust should be viewed as a continuation of the Distributing Trust. The consequences in such a case should be the same as if the trust were domesticated without any change in terms (\textit{e.g.}, by changing the identity of the trustee to a US person). Because domestication of a foreign trust in this manner is treated as a mere continuation of the trust, the throwback rules would not immediately apply. The Receiving Trust would instead inherit the tax attributes of the Distributing Trust, and the throwback rules would be triggered in the future upon a distribution from the Receiving Trust to a US person.\textsuperscript{87}

With respect to a decanting treated as a distribution, the US Receiving Trust will be subject to the reporting requirements under Section 6048(c). Where the decanting is considered a continuation of the Distributing Trust, we assume that the same reporting requirements will continue to apply to the Receiving Trust so that the Service will be on notice of the transfer. We ask that the Service confirm this point.

B. Gain Recognition

In many Private Letter Rulings, the Service has addressed whether a distribution from one trust to another trust causes gain to be recognized under Section 1001.\textsuperscript{88} In considering possible gain recognition on such a distribution, there are two separate issues – first, whether gain should be recognized by the beneficiaries of the Distributing Trust, and second, whether gain should be recognized by the Distributing Trust itself.

1. Gain Recognition by Beneficiaries

As a general matter, gain or loss is realized under Section 1001 upon the conversion of property into cash or upon the exchange of property for other property that differs materially in either kind or extent.\textsuperscript{89} In Cottage Savings v. Comm’r,\textsuperscript{90} the US Supreme Court

\textsuperscript{84} See IRC § 643(a)(6)(C).

\textsuperscript{85} See IRC §§ 665 – 668.

\textsuperscript{86} See, e.g., Henry Christensen III, INTERNATIONAL ESTATE PLANNING § 4.11[3] (2d ed. 2011); Robert C. Lawrence, INTERNATIONAL TAX & ESTATE PLANNING 7-153 (PLI 1996). Further support for this position is found in Section 665(c)(2)(A), which applies the throwback rules to, among other trusts, certain domestic trusts that were previously foreign trusts. If domestication itself triggered the throwback rules, it would not be necessary to apply such rules to domestic trusts with a foreign heritage.

\textsuperscript{87} See Rev. Rul. 91-6, 1991-1 CB 89, where the Service noted that the transformation of a foreign trust into a domestic trust does not eliminate the then applicable 6 percent addition to tax on a foreign-based accumulation distribution.


\textsuperscript{89} See Treas. Reg. § 1.1001-1(a).
adopted an expansive view of when property received in an exchange would be considered to be materially different from the property transferred. The Court determined that “properties are ‘different’ in the sense that is ‘material’ to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or in extent.”

A number of Private Letter Rulings released after the Cottage Savings decision suggest, by implication, that a distribution from one trust to another might constitute a taxable exchange of an interest by each beneficiary of a Distributing Trust for an interest in a Receiving Trust if the beneficiary’s new interest is “materially different” from its old interest. In each of these rulings, the Service found that the beneficiary’s interests in the two trusts were not materially different and therefore that the beneficiary did not recognize gain. We believe that even in a situation where a beneficiary’s interests in a Distributing Trust and a Receiving Trust differ materially, a decision by a trustee to decant trust property should not result in gain recognition to the beneficiary. Unlike the holder of securities in Cottage Savings, a beneficiary of a trust that is decanted by a trustee has not exchanged any interest. Rather, the trustee has taken the action that causes the property to be distributed from the Distributing Trust to the Receiving Trust. No exchange by a beneficiary occurs if the trustee’s actions are authorized by the governing instrument or state law. This conclusion is not inconsistent with Cottage Savings because the beneficiaries’ legal entitlements in the Distributing Trust include the right to have assets distributed to the Receiving Trust.

Other Private Letter Rulings have been consistent with this view. These rulings indicate that a beneficiary will not recognize gain in the case of a distribution to another trust that is authorized by the trust instrument or by local law. For example, in Private Letter Ruling 201134017, the Service stated that because the transfer of assets would be made under the authority granted to the special trustee under the express terms of the trust document, the beneficiaries would not acquire their interests in the new trust as a result of the exchange of their interests, and therefore, the proposed decanting would not result in realization of gain or loss by


91 Id. at 565.


93 See Priv. Ltr. Rul. 200135007 (Sept. 4, 2001). In that ruling, the Service stated that a partition did not result in an exchange because the trust beneficiaries “do not acquire their interest in the individual trusts as a result of an exchange of their interests in the trust, but rather by reason of the authority granted under the [state] law. There is no exchange of property here; instead, the trustee is merely exercising a right to divide the trust as allowed by state law.”

94 See also Treas. Reg. § 1.1001-3(c)(1)(ii), which provides that an alteration of a legal right or obligation that occurs pursuant to the terms of a debt instrument generally is not a modification of the instrument that will cause recognition under Section 1001, whether the alteration occurs automatically by operation of the terms of the debt instrument or whether it occurs as a result of the exercise of an option provided to an issuer or a holder to change the terms of the instrument.

either the trust or any beneficiary.\textsuperscript{96} These rulings also are 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 either in kind or extent if applicable state law or the governing instrument authorizes the severance and the non-pro rata funding.

We recognize, however, that in cases where the decanting could not be achieved in accordance with the trust instrument or state law without the consent of the beneficiary and the beneficiary’s interests in the Receiving Trust differ materially from that of the Distributing Trust, then gain may be recognized by the beneficiary who affirmatively consented to the change.\textsuperscript{97} This position is consistent with Revenue Ruling 69-486,\textsuperscript{98} which ruled that a distribution may result in gain recognition to a beneficiary in a narrow set of circumstances, specifically where the distribution (i) occurs as a result of an agreement by the beneficiaries and, in addition, (ii) is not authorized under the terms of governing instrument or applicable state law. Accordingly, based on Revenue Ruling 69-486, if a beneficiary must consent in order for the trustee to decant, gain might be recognized if the beneficiary’s interests in the Distributing and Receiving Trusts are materially different.\textsuperscript{99}

On the other hand, so long as beneficiary consent is not required under the trust instrument or applicable law, provided the decanting is authorized and effectuated by a non-beneficiary trustee, the beneficiary should not recognize gain even if the beneficial interests in the Distributing and Receiving Trusts materially differ.

2. **Gain Recognition by the Distributing Trust**

There also is a question as to whether a Distributing Trust recognizes gain when appreciated trust assets are distributed to a Receiving Trust. We believe that, as a general matter, there should be no gain recognized by a Distributing Trust in such a situation.

If both the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person for income tax purposes,\textsuperscript{100} no gain should be recognized on the distribution based on principles of Revenue Ruling 85-13.\textsuperscript{101} In this Ruling, the Service


\textsuperscript{97} See Zaritsky, Lane and Danforth, \textit{Federal Income Taxation of Estates and Trusts} (WG&L) ¶ 2.19.

\textsuperscript{98} 1969-2 CB 159.

\textsuperscript{99} We note that a provision requiring that a beneficiary receive notice, or that requires approval by a court or other third party, should not be treated as a right to consent. Similarly, if the beneficiary releases the Trustee, upon a formal or informal accounting, with respect to the period during which the decanting occurred, such release should not be treated as the exercise of a consent right for these purposes. Court approval, however, may affect the GST tax consequences of an exempt trust. See Section VI(B)(2) of this Report.

\textsuperscript{100} See IRC §§ 671-679.

\textsuperscript{101} 1985-1 CB 184. In Revenue Ruling 85-13, the grantor of a trust acquired the corpus of the trust in exchange for the grantor’s unsecured promissory note. The Service determined that the grantor was considered to have borrowed the corpus of the trust; consequently, the grantor was treated as the owner of the trust property under Section 675(3).
concluded that a transaction between a grantor and a trust deemed wholly owned by the grantor under Subchapter J does not give rise to a recognized event because the grantor is considered to own the trust assets for income tax purposes. The Service has cited this principle in concluding that a transaction between two grantor trusts, both of which are treated as wholly-owned by the same individual, does not give rise to a transfer for income tax purposes.\textsuperscript{102}

Moreover, regardless of whether the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person, no gain should be recognized for the same reason that no gain is recognized when a settlor transfers property to a domestic non-grantor trust. There is no amount realized by the settlor, as the settlor is not considered to receive anything in exchange for the transfer. Nonrecognition treatment also is consistent with CCA 200923024 (June 5, 2009), which concludes that the conversion of a non-grantor trust to a grantor trust is not a transfer of property that requires gain to be recognized. And finally, the presence of Section 684 — described in the next paragraph — supports our conclusion that gain generally is not recognized upon a contribution to a (domestic) non-grantor trust. Section 684, which applies to transfers to foreign trusts, would not be necessary if gain generally were recognized on the transfer of assets to a non-grantor trust.

There are two possible exceptions to the general rule of nonrecognition on a transfer of appreciated property from one trust to another. The first such exception results from the application of Section 684. Under Section 684, if a US person transfers property to a foreign non-grantor trust, the transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred, with the transferor recognizing gain. Accordingly, a distribution of appreciated assets from a Distributing Trust that is a domestic trust to a Receiving Trust that is a foreign non-grantor trust will result in gain recognition under Section 684.

A second possible exception to nonrecognition on a transfer of appreciated property from one trust to another (where the Distributing and Receiving Trusts are not both grantor trusts deemed wholly owned by the same grantor) may apply in a situation where the property that is transferred is encumbered with debt in excess of basis or is a partnership interest with a negative capital account. In such a case, gain may result based upon the principles of \textit{Crane v. Comm’r}.\textsuperscript{103} In \textit{Crane}, the Supreme Court held that a taxpayer’s amount realized includes recourse and nonrecourse liabilities from which the taxpayer is discharged.\textsuperscript{104} Based on \textit{Crane}, the Service has concluded in several instances that a termination of grantor trust status results in gain recognition if the trust holds property having liabilities in excess of basis or partnership interests with negative capital accounts.\textsuperscript{105}

\textsuperscript{102} Rev. Rul. 2007-13, 2007-1 CB 684.

\textsuperscript{103} 331 U.S. 1 (1947).

\textsuperscript{104} See also Treas. Reg. § 1.1001-2(a)(1) (“the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition”).

We have considered the interaction between *Crane* and its progeny, on the one hand, and Section 643(e), on the other hand. Section 643(e) provides that gain generally is not recognized on a distribution of appreciated property from a non-grantor trust.\(^{106}\) There does not appear to be any authority as to the interplay of *Crane* and Section 643(e).\(^ {107}\) This uncertainty extends beyond decanting and exists generally where there is an outright trust distribution. We recommend that any forthcoming guidance from the Service address this point and treat trust decanting (except from a grantor trust which is not subject to Section 643(e)) and an outright distribution in a similar fashion. While we believe that existing authority could support either position, if the Service concludes that a distribution of encumbered property with debt in excess of basis (or a partnership interest with a negative capital account) from a non-grantor trust triggers gain, we recommend that such tax treatment be prospective. However, regardless of whether *Crane* overrides Section 643(e) in this context, if the Receiving Trust is treated as a continuation of the Distributing Trust or if both the Distributing and Receiving Trusts are grantor trusts deemed owned by the same person, gain should not be recognized on the distribution.

C. Identity of the Grantor

If property is distributed from one trust to another trust, it is important to be able to identify the “grantor” of the Receiving Trust. Among other reasons, identifying the grantor of the Receiving Trust may be important in order to determine whether the Receiving Trust is a grantor trust under Sections 671 through 679.

Treas. Reg. § 1.671-2(e)(5) provides that if a trust makes a transfer to another trust, the grantor of the Distributing Trust generally will be treated as the grantor of the Receiving Trust. An exception applies if property is distributed from a Distributing Trust to a Receiving Trust pursuant to the exercise of a general power of appointment. In such a case, the person exercising the power of appointment will become the grantor of the Receiving Trust.\(^ {108}\) This result is consistent with Section 2514, which provides that a person who exercises a general power of appointment will be treated as making a transfer of property for gift tax purposes.

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\(^{106}\) Section 643(e) does not apply when the Distributing Trust is a grantor trust. This is because Section 643(e) applies for purposes of Subparts A, B, C and D of Part I of Subchapter J. The grantor trust rules are found in Subpart E of Part I of Subchapter J. Accordingly, in the case of a distribution of property encumbered with debt in excess of basis or a partnership interest with a negative capital account from a grantor trust to a non-grantor trust or to a grantor trust deemed owned by a different person, gain may be recognized under Section 1001.

\(^{107}\) Under Section 643(e), gain is recognized on a distribution of appreciated property from a trust if an election is made to recognize gain under Section 643(e)(3) or if the distribution of appreciated property is made in satisfaction of a pecuniary amount. Section 643(e)(1) provides that “the basis of any property received by a beneficiary in a distribution from an estate or trust shall be (A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for (B) any gain or loss recognized by the estate or trust on the distribution” (emphasis added). It is not clear whether the basis increase in respect of gain recognized on the distribution relates only to a basis increase resulting from gain that is recognized as a result of the application of Section 643 (that is, because an election is made to recognize gain under Section 643(e)(3)).

\(^{108}\) We believe that the foregoing income tax rules are correct and that similar principles should be applied to trust decanting for GST tax purposes.
D. Adding Beneficiaries

If state law or a decanting provision in the Distributing Trust instrument authorizes the Receiving Trust to include beneficiaries who were not included in the Distributing Trust, such a power would likely render the Distributing Trust a grantor trust for income tax purposes. In that regard, with one exception, no state statute allows for the addition of beneficiaries. Under South Dakota law, a trustee may accelerate the interest of a remainder beneficiary by decanting into a trust that provides such a beneficiary with a current interest. In addition, it is possible that future state statutes or provisions of the Distributing Trust instrument may permit the addition of beneficiaries. In cases where state law or the trust instrument permits the addition of beneficiaries, the decanting power will render the Distributing Trust a grantor trust for income tax purposes under Section 674 if the grantor is living. In contrast, if a beneficiary cannot be added – as in the case of every current decanting statute save one – the decanting authority itself will not trigger grantor trust status.

E. Charitable Deduction

1. Contributions to the Distributing Trust

An income tax charitable deduction is available to the grantor with respect to a contribution in trust in limited circumstances. For example, contributions to a trust where the remainder interest is in favor of a charity generally will give rise to an income tax deduction if the trust is a charitable remainder annuity trust or a charitable remainder unitrust (described in Section 664) or a pooled income fund (described in Section 642(c)(5)). Where the charity has an income interest, contributions to the trust also will give rise to an income tax deduction if: (i) the charity's interest is in the form of a guaranteed annuity interest or a unitrust interest; and (ii) the donor is treated as the owner of the interest under the grantor trust rules.

As mentioned earlier, most state statutes specify that the decanting may not reduce the fixed income interest of a beneficiary of a charitable remainder or charitable lead trust. Therefore, so long as the decanting authority may not alter the fixed rights that give rise to the charitable deduction, the authority to decant should not affect the income tax deduction with respect to the funding of the Distributing Trust. In contrast, if the instrument governing the Distributing Trust or state law permits a decanting that may change the charitable interest, no charitable deduction should be available to the taxpayer contributing to the Distributing Trust, even if the trustee does not exercise the decanting power. This is so because, under such limited circumstances, the underlying premise giving rise to the deduction – an ascertainable right ascribed to charity – is not present because it may be defeated. In that regard, we note that even where the Distributing Trust agreement and statutory law are silent, common law principles

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109 IRC § 674.
110 A trustee’s ability to decant in favor of a trust that grants a beneficiary a power of appointment does not constitute a power to add beneficiaries. See infra, Section I(C)(2)(h) of this Report.
111 IRC § 170(f)(2).
112 IRC § 170(f)(2)(B).
113 See Section I(C)(2)(e) and (f) of this Report.
might constrain the authority to decant in a fashion that would defeat charity’s interest. In such cases, the authority to decant similarly should not affect the grantor’s charitable deduction.

2. Distributions from the Receiving Trust Pursuant to a Power of Appointment

A charitable deduction generally is available for a trust distribution if, among other requirements, the payment is made “pursuant to the terms of the governing instrument.” As discussed earlier, a trustee with decanting authority generally may decant in favor of a Receiving Trust which confers a power of appointment upon a beneficiary of the Receiving Trust. This is because, under some specific decanting statutes and common law principles, a trustee with broad discretion to distribute trust property outright to a beneficiary also has the authority to exercise such discretion in favor of the beneficiary in a more limited fashion. If the Receiving Trust includes a power of appointment which specifies that it may be exercised in favor of charity, the subsequent exercise of such a power of appointment in favor of charity should qualify as a payment pursuant to the terms of the governing instrument.

In reaching this conclusion, we have considered Brownstone v. U.S. The facts in that case are distinguishable since the exercise of the power in Brownstone was in favor of the power holder’s estate and not in favor of charity. The payment to charity was made pursuant to the terms of the decedent’s Will and not pursuant to the exercise of the power of appointment. Here, the payment in question is pursuant to the exercise of a power of appointment validly granted under state law.

IV. GIFT TAX ISSUES

Section 2501 imposes the gift tax on “the transfer of property by gift…..” The regulations define the term “gift” as “[a]ny transaction in which an interest in property is gratuitously passed….” to another person. Further, Section 2512(b) provides that if property is transferred for less than full and adequate consideration in money or money’s worth, the excess of the value of the transferred property over the value of consideration received is a gift for gift tax purposes. The gift tax is not limited to transfers made directly by the transferor. Accordingly, any indirect gift in which an interest in property is transferred for less than full and

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114 See, e.g., Mark L. Ascher THE FIDUCIARY DUTY TO MINIMIZE TAXES, 20 Real Prop. Prob. & Tr. J. 663 (1985). See also UNIFORM TRUSTEES’ POWERS ACT (1964) § 3(b), 7B U.L.A. 743 (stating that a trustee has "a duty not to exercise any power...in such a way as to deprive the trust of an otherwise available tax exemption, deduction or credit...").

115 IRC§ 642(c)(1).

116 See infra, Section I(C)(2)(h) of this Report.


120 IRC § 2512(b).

121 IRC § 2511(a).
adequate consideration, regardless of the means or device employed, is a gift subject to gift tax.\textsuperscript{122} Consequently, transfers that result in the shifting of an economic right or benefit to another person that also reduces the potential gross estate of the transferor generally are within the scope of the gift tax.\textsuperscript{123}

The gift tax regulations state that donative intent on the part of the transferor is not an essential element in determining whether a gift for gift tax purposes has been made.\textsuperscript{124} The application of the tax is, instead, "based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor."\textsuperscript{125} Although donative intent is not required for a gift, the Tax Court has held that a voluntary act of transfer is required for a gift subject to the gift tax.\textsuperscript{126} Specifically, the Tax Court stated "we do not believe that a taxable event can occur for gift tax purposes unless there is first and in fact an act of transfer by the donor; and there can be no act of transfer unless the act is voluntary and the transferor has some awareness that he is in fact making a transfer of property, that is, he must intend to do so."\textsuperscript{127} Further, the Code and Treasury Regulations make it clear that the gift tax is the primary and personal liability of the transferor and is imposed upon the transferor’s act of making the transfer.\textsuperscript{128}

Therefore, for purposes of evaluating the gift tax consequences of decanting trust assets, the analysis turns on the identity of the individual who participates in, consents to or, perhaps, acquiesces in a decision to decant the assets of a trust and the relationship or connection of such individual to the Distributing Trust and the Receiving Trust.

A. **Trustee as Beneficiary**

Generally, no taxable gift results from a trustee’s distribution of trust property to a beneficiary where the trustee has no beneficial interest in the trust.\textsuperscript{129} A taxable gift may arise, however, upon the distribution of trust assets if the trustee has a beneficial interest in the trust.

\textsuperscript{122} Treas. Reg. § 25.2511-1(c)(1).
\textsuperscript{123} See, e.g., Dickman v. Comm’r, 465 US 330 (1984) (where an interest-free demand loan between family members resulted in a gift); Estate of Lang v. Comm’r, 613 F.2d. 770 (9th Cir. 1980) (where a mother made a taxable gift to her son by permitting the statute of limitations to run on the collection of loans made to him). See also TAM 200014004 (where surviving spouse acquiesced in payment of excess trustees’ fees to her children and such excess payments were deemed taxable gifts because the payment of the fees facilitated her estate planning by transferring assets to her children).

\textsuperscript{124} Treas. Reg. § 25.2511-1(g)(1).
\textsuperscript{125} Id. See also Comm’r v. Wemyss, 324 US 303 (1945).


\textsuperscript{127} Id. at 663. See also Harris v. Comm’r, 340 US 106 (1950) (where the Court stated that if a contractual division of marital assets was wholly conditional upon the entry of a decree by the court, then the distribution of the assets could not be a voluntary promise or agreement that resulted in a transfer subject to the gift tax).

\textsuperscript{128} See Treas. Reg. § 25.2511-2(a).

\textsuperscript{129} See Treas. Reg. § 25.2511-1(g)(1) (“A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee...”).
and is permitted to participate in the distribution decision, unless the distribution may be made only pursuant to an ascertainable standard.

These same gift tax principles should apply where a trustee exercises the power to decant trust assets. Accordingly, where the trustee of the Distributing Trust has no beneficial interest in the Distributing Trust, a trust decanting should not give rise to any gift tax issues, even where there is a shift of a beneficial interest. However, if an individual is a trustee with an unrestricted power to decant trust assets and also is a discretionary beneficiary of the trust over which he or she holds the decanting power, the exercise of the decanting power by such trustee/beneficiary (which reduces his or her beneficial interest) should result in a taxable gift. It is irrelevant for gift tax purposes that the trustee/beneficiary may be acting solely in a fiduciary capacity when exercising the decanting power if such exercise by the trustee/beneficiary results in a shift of any portion of his or her beneficial interest to another beneficiary. In any event, in most cases, this gift tax issue will not arise because the trustee/beneficiary often will not have the power to decant, either as a result of prohibitions in the trust instrument or state law.

B. Consent of Beneficiary

As noted earlier, for a taxable gift to occur, the transferor must make a voluntary transfer. In a trust decanting, the beneficiary is not making the requisite voluntary transfer because the trustee (as opposed to the beneficiary) is the party effectuating the decanting decision. Indeed, in many states, the trustee is not even required to provide notice to the beneficiary of the exercise of the decanting power. Consequently, unless the beneficiary also is a trustee participating in the decanting decision (as discussed earlier), the beneficiary will not be deemed to have made a taxable gift when the trustee exercises the power to decant trust assets.

An exception may be appropriate when the governing instrument or state law requires consent of a beneficiary in order for the trustee to exercise the power to decant trust assets. In that instance, the consent by the beneficiary to reduce his or her beneficial interest will be a taxable gift. Currently, Nevada is the only state that requires a trustee to secure a

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130 Treas. Reg. § 25.2511-1(g)(2).
131 Id. (“If a trustee has a beneficial interest in trust property, a transfer of property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument”).
133 See Treas. Reg. § 25.2511-1(c)(1) (gratuitous transfer regardless of means or device is gift subject to gift tax).
134 See, e.g., EPTL § 10-6.6(s)(2); MO REV. STAT. § 456.4-419(2); N.C. GEN. STAT. § 36C-8-816.1(d); N.H. RSA. § 564-B:4-418(c); NEV. REV. STAT. § 163.556.3.
136 See Sexton v. US, 300 F.2d 490 (7th Cir. 1962) (holding that where two-thirds vote of beneficiaries was required to extend the trust term, the beneficiaries that joined in unanimous consent to exercise the trust term resulted in a taxable gift of the beneficiary’s right to receive trust property at the end of the trust’s original term); Rev. Rul. 86-39, 1986-1 C.B. 301 (ruling that beneficiary made taxable gift where beneficiary executed release for
beneficiary’s consent to a decanting in circumstances where the decanting eliminates or limits a beneficiary’s interest in the Receiving Trust. 137

Other states require that notice be given to the beneficiary of a trust in advance of any exercise of the decanting power. 138 In these states, the beneficiaries have no legal right under state law to prevent the decanting, but may maintain an action against the trustee for breach of fiduciary duty. If the decanting is consistent with state law and the terms of the governing instrument, the courts will not interfere with the trustee’s exercise of the decanting power except in the case of an abuse of discretion. 139 As a result, mere notice of the decanting is not tantamount to the beneficiary possessing the ability to prevent the trustee from exercising the power to decant. If the beneficiary cannot prevent a decanting, the beneficiary’s acquiescence (or failure to object) to the decanting is not a voluntary transfer that will be subject to gift tax. Similarly, a beneficiary’s voluntary consent or release of the trustee will not expose the beneficiary to gift tax, so long as consent is not required.

C. Granting a Power of Appointment

As discussed earlier, a trustee with decanting authority generally may decant in favor of a Receiving Trust that confers a power of appointment upon a beneficiary of the Receiving Trust. 140 Granting a power of appointment does not alter the analysis that the decanting itself is an exercise of discretion by the trustee, and not the Distributing Trust’s beneficiary, and therefore is not a gift (assuming the trustee exercising the decanting power has no beneficial interest in the Distributing Trust). However, a taxable gift may result upon the subsequent exercise of the power of appointment over the trust corpus by the beneficiary if the exercise of the power results in the relinquishment of the powerholder’s rights or interests 141 or, alternatively, under the Delaware tax trap. 142

137 NEV. REV. STAT. § 163.556(2)(e).

138 See, e.g., EPTL § 10-6.6(b)(2) (2011); FLA. STAT. § 736.04117(4); IC § 30-4-3-36; N.C. GEN. STAT. § 36C-8-816.1(f)(2) and (3); S.D. CODIFIED LAWS §§ 55-2-18.

139 See RESTATEMENT (THIRD) OF TRUSTS, § 50.

140 See infra, Section I(C)(2)(h) of this Report.

141 See Treas. Reg. § 25.2524-1(b)(2) (if lifetime exercise of a special power of appointment results in the relinquishment by the powerholder of a separate interest in the trust as a life income beneficiary, a taxable gift results under § 2511); Estate of Ruth B. Regester, 83 T.C. 1 (July 2, 1984) (exercise of a special power of appointment by the owner of a life estate made a gift subject to gift tax). See also Rev. Rul. 79-327 (donee’s exercise of the power of appointment resulted in a taxable gift). In rare instances in which a potential gift arises because a trustee/beneficiary exercises the decanting authority, or because a decanting requires a beneficiary’s consent, the gift may be rendered incomplete if the beneficiary who is deemed to have made the gift is given a power of appointment. See Treas. Reg. § 25-2511(b); Priv. Ltr. Rul. 200715005 (Jan. 3, 2007). But see CCA 201208026.

142 See supra Section IV(E) of this Report.
D. Decanting to a Grantor Trust

We have also considered whether a trust decanting from a Distributing Trust that is a complex trust to a Receiving Trust that is a grantor trust gives rise to any gift tax issues. In Revenue Ruling 2004-64, the Service issued guidance on the gift tax consequences of the grantor’s payment of income tax attributable to a grantor trust.\(^{143}\) The Service ruled that the grantor's payment of the income tax attributable to the inclusion of the trust income in his or her taxable income is not a gift to the trust beneficiaries because the payment of such tax is in discharge of the grantor’s own liability, not that of the trust or its beneficiaries.\(^ {144}\) A similar rule applies to a trust that converts from a non-grantor trust to a grantor trust — for example, by virtue of a change of trustees.\(^ {145}\) Under these principles, a taxable gift similarly should not result from a decanting where the Distributing Trust is a non-grantor trust and the Receiving Trust is a grantor trust.

E. The Delaware Tax Trap

In limited circumstances, the exercise of a limited power of appointment will be a taxable gift by the person exercising the power. Under this rule, referred to colloquially as “the Delaware Tax Trap,” if a holder of a limited power of appointment exercises that power during such holder’s lifetime, and such exercise creates another power which, in turn, can be exercised to postpone the vesting of the trust property for a period ascertainable without regard to the date of creation of the first power, the holder’s exercise of the first power of appointment will be deemed a transfer subject to gift tax.\(^ {146}\) The Delaware Tax Trap applies upon the exercise of the first power, whether or not the second power holder exercises the second power, if the second power may be exercised to extend the perpetuities period beyond the period applicable under the terms of the trust instrument that created the first power.

At first blush, it may seem that the trustee’s exercise of the decanting power may trigger a taxable gift if the Receiving Trust grants a power of appointment to the trust beneficiary and the vesting period does not relate back to the period applicable to the Distributing Trust.\(^ {147}\) However, the legislative history indicates that the Delaware Tax Trap rules were not intended to apply to fiduciary powers of appointment, such as a trustee’s discretionary power to invade principal.\(^ {148}\) In addition, the Delaware Tax Trap should not apply to a decanting pursuant to state law since most of the state decanting statutes require that the permissible period for the postponement of vesting of interests in trust property, or the suspension of power of alienation over trust property, must be determined by reference to the date of creation of the original power.


\(^{144}\) Id.

\(^{145}\) See IRC § 674 (a trust under which the grantor or a nonadverse party has the authority to make discretionary distributions is a grantor trust, unless at least half the trustees are not related or subordinate to the grantor (and none of whom is the grantor or the grantor’s spouse)).

\(^{146}\) IRC § 2514(d).

\(^{147}\) See, e.g., William R. Culp, Jr. & Briani Bennett Mellen, Use Of Trust Decanting to Extend the Term of Irrevocable Trusts, 37 EST PLN 3 (2010).

\(^{148}\) See S. REP. No. 82-382, at 1 (1951), as reprinted in 1951 U.S.C.C.A.N. 1535, 1535.
in the Distributing Trust.\textsuperscript{149} In addition, even if a trustee’s exercise of the decanting power otherwise falls under Section 2514(d), such exercise should not result in a taxable gift by the trustee so long as the trustee does not have a beneficial interest in the property subject to the decanting.\textsuperscript{150} Since a transfer by a trustee of property in which such trustee has no beneficial interest does not constitute a gift by the trustee, as discussed earlier, a decanting by a trustee with no beneficial interest in the trust property should not result in a taxable gift.\textsuperscript{151} We recommend that the Service confirm this point.

The analysis differs with respect to powers of appointment granted to a beneficiary of the Receiving Trust. If a beneficiary is granted a limited power of appointment in the Receiving Trust and exercises that power, in further trust, and creates another power that can be exercised to extend the perpetuities period applicable to the Receiving Trust, the exercise of the power by the beneficiary of the Receiving Trust will be a taxable gift under Section 2514(d).\textsuperscript{152}

F. Gift Tax Deductions and Exclusions

The donor is entitled to certain deductions and exclusions from the gift tax for gifts in trust, provided the trust instrument contains certain provisions. For example, under Section 2503(c), the annual gift tax exclusion is available for trusts that meet certain criteria. In addition, under Sections 2522 and 2523, charitable and marital deductions are available if the trust meets the statutory requirements. More specifically, the charitable interest must meet the criteria of a charitable remainder trust or pooled income fund under Sections 664 and 642(c)(5), or qualify under Section 2522(c)(2)(B) for certain fixed interests. To qualify for the marital deduction, the spouse’s interest in the trust must meet the requirements set forth under Section 2523. If the decanting power can defeat the rights in the Distributing Trust that give rise to the deduction or exclusion, then the Distributing Trust should not be entitled to the deduction or exclusion. If, on the other hand, the decanting authority under the trust instrument or state law prohibits the trustee from defeating any of the rights that give rise to a gift tax deduction or exclusion, the existence of the decanting power should have no effect on the availability of the deduction or exclusion to the donor of the Distributing Trust.

As mentioned earlier in this Report, most state statutes prohibit a decanting that will alter fixed rights or otherwise jeopardize the marital and charitable deductions. Many state statutes further ensure that a decanting may not change a beneficiary’s right or interest in the trust that gives rise to the annual exclusion for gift tax purposes. Some state statutes provide similar protection for gifts that qualify for the annual exclusion based on a beneficiary’s withdrawal rights over contributions to the trust. Absent protection in the Distributing Trust agreement or state law (including common law principles), decanting authority that enables the trustee to defeat a right that gives rise to an annual exclusion or gift tax deduction will jeopardize that deduction for the Distributing Trust.

\textsuperscript{149} See, e.g., 12 DEL. C. § 3528(c); EPTL § 10-6.6(p).
\textsuperscript{150} See generally Culp & Mellen, supra note 147.
\textsuperscript{151} Id.
\textsuperscript{152} IRC § 2514(d).
V. ESTATE TAX ISSUES

Generally, a trustee’s exercise of the decanting power will not result in any estate tax consequences. Only specific situations may trigger the estate tax when a decanting occurs.

A. Grantor’s Involvement in Decanting

We have considered whether the grantor’s possible involvement in the decanting may have estate tax implications for the grantor. In that regard, we note that, in some jurisdictions, even if the grantor is a trustee, the grantor is not permitted to participate in the exercise of the decanting power.\(^{153}\) We further note that at least one decanting statute requires that notice be given to the grantor and that the decanting be consistent with the grantor’s intent.\(^{154}\) Merely providing notice of the decanting to the grantor will not give rise to a retained power in the grantor over the trust property, causing the trust assets to be included in the grantor’s gross estate. Notice does not enable the grantor to control the trustee’s discretion and does not give the grantor any power which enhances or shifts the rights of the beneficiaries of the Distributing Trust. Furthermore, acting in a fashion consistent with the grantor’s intent is a fundamental fiduciary duty, provided such action is in accordance with the trust instrument and applicable law.

The regulations provide that Section 2038 does not apply if the decedent’s power adds nothing to the rights of the parties under local law.\(^{155}\) The regulations confirm the rule set forth in *Helvering v. Helmholz*,\(^{156}\) where the Supreme Court held that a trust that could be revoked by the grantor together with all other beneficiaries was not includible in the grantor’s gross estate because the revocation provision in question added nothing to what the parties could have accomplished under the law of trusts.\(^{157}\) Indeed, in Private Letter Ruling 201015025 (Mar. 16, 2010), the Service determined that even where the grantor consented to a modification of a trust pursuant to a state statute, such consent did not constitute an exercise of a retained power over the trust that would cause the trust assets to be included in the grantor’s estate under Sections 2036 and 2038.\(^{158}\)

A grantor also is not deemed to have control simply because of a personal relationship between the grantor and the trustee, or because the trustee tends to follow the grantor’s wishes in exercising discretion.\(^{159}\) The trustee must adhere to fiduciary duties. So long

\(^{153}\) See, e.g., EPTL § 10-6.6(s)(1); O.R.C. § 5808.18(L)(2)

\(^{154}\) EPTL § 10-6.6(h) and (j)(2).


\(^{156}\) 296 US 93 (1935).

\(^{157}\) Id. at 97.

\(^{158}\) Priv. Ltr. Rul. 201015025 (“. . . Trust A and Trust B are being modified pursuant to authority granted under Statute 1; accordingly, Settlor’s act of consenting to the modifications does not constitute the exercise of any retained power over the trusts. We therefore conclude that the proposed modifications to Trust A and Trust B will not cause any portion of the assets of Trust A or Trust B to be includible in the gross estate of Settlor. . . .”).

\(^{159}\) See Estate of Helen S. Wall, 101 T.C. 300 (Oct. 12, 1993) (where the court held that the trustee has a duty to exercise powers exclusively for the benefit of the beneficiaries and, therefore, without any evidence of a fraudulent side agreement regarding the manipulation of the administration of the trust between the grantor and the..."
as the trustee is obligated to act in a fashion consistent with those duties, there is no retention of a power or right by the transferor that would cause the trust assets to be included in the grantor’s gross estate.\(^\text{160}\)

**B. Delaware Tax Trap**

Similar to the Delaware Tax Trap under the gift tax rules, discussed earlier, property subject to a limited testamentary power of appointment will be includible in a decedent’s gross estate for estate tax purposes if the decedent exercises the testamentary power of appointment in further trust to create a new power that may be exercised in a manner that postpones the vesting of such property or suspends the power of alienation of such property beyond the period applicable to the first power.\(^\text{161}\) Section 2041(a)(3) provides that the exercise of a limited power of appointment in such a manner by the decedent will be considered the exercise of a general power of appointment.\(^\text{162}\)

The decanting power, which is exercisable by a trustee during the trustee’s lifetime, will not result in estate tax inclusion for the trustee. However, if a beneficiary of the Receiving Trust is granted a limited testamentary power of appointment over the trust property, and exercises that power, in further trust, by creating another power that may postpone the vesting of the trust property beyond the perpetuities period applicable to the Receiving Trust, the property subject to the power will be included in the Receiving Trust’s beneficiary’s estate for estate tax purposes.\(^\text{163}\)

**C. Charitable and Marital Deductions**

Under Section 2055, a charitable deduction is available for estate tax purposes with respect to a charitable interest in trust only if the charity’s interest meets specific criteria to ensure that such interest is a fixed determinable amount. Similar to the gift tax rules, the deduction is available for interests in a charitable remainder annuity trust or a charitable remainder unitrust (described in Section 664), a pooled income fund (described in Section 642(c)(5)) and for an income interest in the form of a guaranteed annuity interest or a unitrust interest.

With respect to the marital deduction, certain limited trust interests qualify for the marital deduction. For example, under Section 2056(b)(7), a trust that meets the definition of

\(^\text{160}\) See Estate of Hilton W. Goodwyn, T.C. Memo 1973-153. See also Byrum, 408 US 125 (suggesting that a grantor’s influence over fiduciaries is legally irrelevant; even if the fiduciary is prevailed upon by the grantor to breach the fiduciary duties, the grantor in creating the trust does not retain any “right” to affect beneficial enjoyment within the meaning of 2036(a)).

\(^\text{161}\) IRC § 2041(a)(3).

\(^\text{162}\) Id.

\(^\text{163}\) Id.
“qualified terminable interest property” will be deemed to have passed to the surviving spouse and therefore will be eligible for the marital deduction. Qualifying terminable interest property must provide the spouse with all of the trust income payable at least annually, and no person may appoint the trust property to anyone other than the spouse.\(^{164}\)

If a Distributing Trust agreement or state law permits a decanting that could defeat the rights of charity or a spouse that give rise to the estate tax charitable or marital deduction, the deduction should not be available to the estate. However, as mentioned earlier, most decanting statutes do not permit a decanting that may change the interest of a beneficiary which gives rise to an estate tax marital or charitable deduction.\(^{165}\) Virtually all state decanting statues prohibit any decanting that could reduce any such fixed interest. Other statues also specifically prohibit any exercise of the decanting power that would jeopardize a deduction or exclusion under certain provisions of the Code, including the charitable and marital estate tax deductions under Sections 2055 and 2056. In addition, common law principles generally prohibit a trustee from exercising a power that would negate tax benefits.

VI. GENERATION-SKIPPING TRANSFER TAX ISSUES

A. Overview of Generation-Skipping Transfer Tax

As part of the Tax Reform Act of 1986,\(^{166}\) Chapter 13 was added to the Code, imposing a tax on certain lifetime and testamentary transfers of property made after October 22, 1986\(^{167}\) to or for the benefit of beneficiaries who are assigned to generations two or more below the generation of the transferor.

1. Generation-Skipping Transfers

Three types of transfers trigger the GST tax: a direct skip, a taxable distribution and a taxable termination.\(^{168}\) Each one involves a transfer to a “skip person,” an individual two or more generations below the transferor’s generation or a trust the current beneficiaries of which are all assigned to generations two or more below that of the transferor.\(^{169}\) A direct skip is a transfer subject to federal gift or estate tax under Chapter 11 or Chapter 12 made to a skip person. A taxable distribution is a distribution from a trust to a skip person, other than a direct skip or a taxable termination.\(^{170}\) A taxable termination is the termination of a beneficiary’s interest in a trust (by death, lapse of time, release of power, or otherwise) unless one of the following exists: (i) a transfer occurs that is subject to federal gift or estate tax, (ii) immediately

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164 IRC § 2056(b)(7)(B)(ii).
165 See Section I(C)(2)(f) of this Report.
166 P.L. 99-514.
167 October 22, 1986 is the date of enactment of the Tax Reform Act of 1986.
168 IRC § 2611; Treas. Reg. § 26.2612-1.
169 In the case of a trust with no current beneficiaries, the trust will be a skip person if no distribution (other than one that has a less than 5% probability of occurrence) may be made to anyone other than a skip person, that is, a “non-skip person”). See generally Treas. Reg. § 26.2612-1(d).
170 IRC § 2612(b).
after the termination of such interest, a non-skip person has an interest in the property, or (iii) at no time after the termination of such interest may a distribution be made to a skip person.  

2. **Identifying the Transferor**

The determination as to whether a GST event has occurred is made by reference to the transferor of the property. The transferor generally is the person with respect to whom the property was most recently subject to the federal estate or gift tax. With respect to property passing at death, the transferor generally is the decedent and, for lifetime gifts, the transferor generally is the donor. However, there are important exceptions to the general rules. Under Section 2653(a), if property remains in trust after a GST event, a determination of whether a subsequent distribution of property from the trust (or a termination of an interest) is a GST event is made as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the GST event. We refer to this rule as the “Move Down Rule.”

3. **Transfers by Non US Persons**

Chapter 13 applies in limited circumstances to transfers by a person who is neither a citizen nor a domiciliary of the US (referred to hereinafter as a nonresident alien or “NRA”). Specifically, only transfers by a NRA (or distributions from trusts funded by a NRA) that are (or previously were) subject to US gift or estate tax will be subject to GST tax. In this regard, it is important to note that the US gift tax applies to transfers by NRAs of US real and tangible personal property and the US estate tax applies generally to the US situs assets in the NRA’s estate.

4. **GST Exemption**

Every individual citizen, resident and NRA has a GST exemption that he or she (or his or her executor) may allocate to transfers made during life or at death. The GST exemption generally is equal to the basic exclusion amount under Section 2010(c), which is currently $5,120,000. An individual may allocate GST exemption to a transfer that is

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172 IRC § 2652(a). See also Treas. Reg. § 26.2611-1. A transfer is subject to gift tax for this purpose without regard to exemptions, exclusions, deductions and credits. Treas. Reg. § 26.2652-1(a).

173 For example, the transferor of property set aside in a marital deduction trust for which a special election is made under Section 2652(a)(3) is the deceased spouse who created the trust, despite the fact that the trust assets will have been subject to estate tax in the surviving spouse’s estate before passing to the next generation. In addition, if the donor’s spouse splits the gift pursuant to Section 2513, each spouse is treated as the transferor of one-half of the gift for GST tax purposes. See, e.g., Priv. Ltr. Rul. 200218001 (May 3, 2002).

174 IRC § 2653(a).


176 See IRC §§ 2501a(2) and 2103.

177 IRC §§ 2631 and 2632; Treas. Reg. § 26.2632-1.

178 This discussion is based on current law, which is scheduled to sunset on December 31, 2012. Also note that Treas. Reg. § 26.2663-2(a) states that “[e]very NRA transferor is allowed a GST exemption of $1,000,000.”
immediately subject to the GST tax, such as a direct skip, or to property transferred in trust that is not immediately subject to GST tax, but which may attract a GST tax in the future. The transferor may make an affirmative allocation of GST exemption to a transfer. In addition, there are default rules that automatically allocate GST exemption to certain transfers in the absence of an express allocation provided that the transferor does not elect out of the default rules.  

5. **Inclusion Ratio**

The amount of the GST tax is determined by multiplying the taxable amount (generally, the value of the property subject to GST tax) by the applicable rate. The applicable rate, in turn, is the product of the maximum federal estate tax rate then in effect and the inclusion ratio with respect to the transfer. The inclusion ratio is determined by subtracting the “applicable fraction” from one. The applicable fraction generally is a fraction, the numerator of which is the amount of GST exemption allocated to the transferred property and the denominator of which is the value of the transferred property on the effective date of the GST exemption allocation, with certain adjustments for tax payments and deductions.

If no portion of the transferor’s GST exemption is allocated to the transferred property, it will have an inclusion ratio of one. With an inclusion ratio of one, the full amount of the property will be subject to the GST tax at the highest federal estate tax rate. In contrast, if the transferor allocates GST exemption to the full amount of transferred property, the inclusion ratio will be zero, and accordingly, no GST tax will be due since the applicable rate (the product of the maximum federal estate tax rate and the inclusion ratio) will be zero. In addition, distributions from any trust with a zero inclusion ratio will not attract a GST tax. If the transferor allocates GST exemption to a portion, but not all, of the transferred property, the inclusion ratio will be a fraction between zero and one, and the GST tax will be below the maximum federal estate tax rate.

Certain transfers that are not treated as taxable gifts under the Code, such as transfers that qualify for the annual exclusion under Sections 2503(b) and (e), are assigned a zero inclusion ratio, and therefore, will not attract any GST tax.

6. **Trusts Exempt from GST Tax**

There are three types of trusts that are not subject to the GST tax. As mentioned earlier, distributions of property from trusts with an inclusion ratio of zero will not give rise to a

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179 IRC § 2632.
181 IRC § 2602.
182 IRC § 2641.
183 IRC § 2642(a)(1).
184 IRC § 2642(a)(2).
185 Id.
186 IRC § 2642(c).
GST tax. In addition, trusts that were irrevocable on or before September 25, 1985 are exempt from GST tax so long as there have been no additions to the trusts (either actual or constructive) after September 25, 1985 (“Grandfathered Trusts”). 187 The final category of trusts to which the GST tax does not apply are trusts created by a NRA that were not subject to the gift or estate tax.

B. GST Tax Consequences of Decanting

In this section, we consider the GST tax consequences of decanting with respect to trusts that are exposed to the GST tax (that is, trusts with an inclusion ratio greater than zero). We further analyze the effect of decanting on trusts otherwise exempt from GST tax.

1. Trusts that Are Exposed to the GST Tax

As mentioned earlier, a trust decanting generally should be treated as a distribution by the trustee for income and gift tax purposes. We recommend that the same principles apply for GST tax purposes. In the case of a decanting of the entire trust, the tax attributes of the Receiving Trust flow from the Distributing Trust. Therefore, in identifying the transferor in order to determine whether a GST event has occurred, we recommend that the Service confirm that the person who is the transferor of the Distributing Trust also be the transferor of the property transferred to the Receiving Trust, unless the decanting triggers a gift or estate tax. If the decanting triggers a gift or estate tax, the identity of the transferor should be that person with respect to whom the gift or estate tax most recently applied.

As a result, a decanting will be a GST event if the Receiving Trust is a skip person with respect to the transferor of the Distributing Trust. In addition, distributions from the Receiving Trust will attract a GST tax if the beneficiary is a skip person with respect to the transferor of the Distributing Trust, taking into account the Move Down Rule, if applicable. 188 The decanting itself may be a taxable termination if, for example, after the decanting no beneficiary of the Receiving Trust is a non-skip person with respect to the transferor of the Distributing Trust.

Where less than the entire Distributing Trust is decanted, no GST tax should apply with respect to any property remaining in the Distributing Trust. Thus, if a taxable distribution is deemed to occur as a result of some property being decanted to the Receiving Trust, the GST tax should be the liability of the Receiving Trust’s trustee under Section 2603(a)(1); the property remaining in the Distributing Trust will not attract an immediate GST tax.

187 September 26, 1985 was the date that Congress first considered the provisions of Chapter 13 under the legislation that resulted in the Tax Reform Act of 1986. That date was used as the effective date for grandfathered trust status. See generally Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L) ¶ 1805[2][a].

188 See IRC § 2653(a).
2. **Grandfathered Trusts**

As mentioned earlier, the GST tax does not apply to trusts that were irrevocable on or before September 25, 1985 so long as there have been no additions to the trust (either actual or constructive) after September 25, 1985. Proscribed additions will cause a Grandfathered Trust to lose its GST exempt status.\(^{189}\)

In 2000, Treasury adopted regulations that provide safe harbor rules for when a modification of a Grandfathered Trust will affect the GST exempt status of the trust.\(^{190}\) Two of the safe harbor provisions specifically address modifications resulting from a trust decanting.\(^{191}\)

(a) **Decanting Authorized When Trust Became Irrevocable**

The regulations provide that a modification of an exempt trust due to a trust decanting will not taint GST exempt status if (1) either (i) authority exists under the instrument creating the Distributing Trust permitting the trustee to appoint in further trust without the consent or approval of any beneficiary or court, or (ii) at the time that the Distributing Trust became irrevocable, applicable state law permitted such a distribution without the consent or approval of any beneficiary or court; and (2) the terms of the governing instrument of the Receiving Trust do not extend the time for vesting of any beneficial interest in the trust beyond 21 years plus lives in being at the date the Distributing Trust became irrevocable.\(^{192}\)

Since the first decanting statute was enacted in New York in 1992, a Grandfathered Trust, which by definition was irrevocable on September 25, 1985, may not rely on statutory law to qualify under this exemption. Therefore, a Grandfathered Trust will fall within this safe harbor only if the trust instrument permits the decanting (without the consent of any beneficiary or the court) or if the applicable state common law in existence as of the date the trust became irrevocable permitted the trustee to appoint in further trust, and the Receiving Trust does not extend the time for vesting beyond the common law perpetuities period measured by reference to the date the original trust became irrevocable.

(b) **No Shift in Beneficial Interests**

The second safe harbor provides that a decanting will not jeopardize the exempt status of a Grandfathered Trust so long as the Receiving Trust’s provisions (i) do not cause a beneficial interest in the trust property to be shifted to a beneficiary at a lower generational level than the original beneficiaries of that interest for GST tax purposes, and (ii) do not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the

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\(^{191}\) Treas. Reg. § 26.2601-1(b)(4)(i). The private letter rulings prior to that date adopted the position that a modification of an exempt trust that changed the quality, quantity, value or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust after the effective date of the GST tax will forfeit the exempt status of the trust. See, e.g., Priv. Ltr. Rul. 200052007 (Jan. 2, 2001) and Priv. Ltr. Rul. 200006001(Feb. 14, 2000). The provisions of Treas. Reg. § 26.2601-1(b)(4)(i) set forth a different set of rules.

A modification will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.

This regulation confirms that, in these cases, where the decanting authorization arose after the Distributing Trust became irrevocable, a Receiving Trust will not be subject to GST tax if the only changes to the Distributing (Grandfathered) Trust are administrative in nature, in those cases where the decanting authorization arose after the Distributing Trust became irrevocable. It further extends exempt status to the Receiving Trust even if the changes are substantive in nature, provided that there is no shift of a beneficial interest to a lower generation and the time for vesting of any beneficial interest is not extended.

We believe that converting a Grandfathered Trust which is a complex trust (for income tax purposes) to a grantor trust should not taint GST exempt status. The regulations provide that a "modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust." Moreover, as confirmed by Revenue Ruling 2004-64, the grantor’s payment of the income tax attributable to the inclusion of the trust’s income in the grantor’s taxable income is not a taxable gift. If the payment of income tax is not considered to be a gift, it follows that there is no deemed transfer to the trust when the grantor pays the income tax. If there is no deemed transfer to the trust when the grantor pays the income tax, it appears that there is no shift to a beneficiary in a lower generational slot. We recommend that the Service confirm this point in future guidance.

3. Exempt Trusts Due to Allocation of GST Exemption

There is no regulation specifically addressing modifications of trusts that are exempt from GST tax because of the allocation of the GST exemption (rather than due to grandfather protection). Nevertheless, the Service has stated that the regulations dealing with Grandfathered Trusts, by analogy, are relevant. The Service has noted that “[n]o guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a Grandfathered Trust should similarly not affect the exempt status of such a trust.”

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194 Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2). (“If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation…than the person or persons who held the beneficial interest prior to the modification.”).
We recommend that Service clarify that the two safe harbors directly applicable to decanting Grandfathered Trusts apply, with certain modifications, to a trust that is exempt from GST tax as a result of an allocation of GST exemption. With respect to the first safe harbor, we recommend that a modification of a trust to which the transferor’s GST exemption was allocated should not taint GST exempt status if (1) either (i) authority exists under the Distributing Trust permitting a trustee to appoint in further trust without the consent or approval of any beneficiary or court, or (ii) applicable state law permits such a distribution, irrespective of whether the law so permitted at the time that the Distributing Trust became irrevocable; and (2) the terms of the governing instrument of the Receiving Trust do not extend the time for vesting of any beneficial interest in the trust beyond 21 years plus lives in being at the date the Distributing Trust became irrevocable. Under these circumstances, the trustee continues to be limited to the common law rule against perpetuities, unless the Distributing Trust was not so limited, and must have authority either under the trust instrument or state law. Because the transferor took affirmative steps to allocate GST exemption to the Distributing Trust, the decanting authority as of the date that the trust became irrevocable, in our view, should not be the focus of the inquiry. Rather, once GST exemption has been allocated, so long as the exercise of the decanting power does not give rise to a gift or estate tax, and does not extend the permissible perpetuities period in the Distributing Trust, we believe that the relevant inquiry should be whether decanting is presently authorized. There is no reason that a trustee’s decanting should affect the GST exempt status.

4. **Trusts Created by NRAs**

We also recommend that the Service confirm that a decanting should not affect the exempt status of a trust created by an NRA which did not give rise to a US gift or estate tax. This is the case, in our view, even if the perpetuities period is extended or there are other changes in beneficial interests. This type of trust is outside the GST tax system, unless there is an event which causes the trust property to be subject to US gift or estate tax.

5. **Loss of GST Exempt Status**

We further recommend guidance concerning the GST tax consequences of the loss of GST exempt status by a trust that is exempt from GST tax (either due to Grandfathered Trust status or the allocation of exemption). With respect to Grandfathered Trusts, we recommend applying the GST tax rules prospectively. Solely for purposes of ascertaining the identity of the transferor (to determine whether future GST events occur), we recommend that the rules under Chapter 13 be applied to the trust from inception. Accordingly, in analyzing the GST tax consequences of a tainted Grandfathered Trust, the Move Down Rule would apply.\(^{200}\)

With respect to trusts that are exempt by reason of the allocation of GST exemption, a decanting that taints GST exempt status should cause an immediate loss of exempt

\(^{200}\) For example, if the Grandfathered Trust created by grandfather for the benefit of grandchild required a principal distribution to the grandchild at age 40, and such trust was decanted in a manner that taints GST exempt status, there should be no immediate GST tax and subsequent distributions to the grandchild will not be GST events. Applying the Chapter 13 rules solely for determining the identity of the transferor after the funding of the trust, the deemed transferor will be the grandfather’s child (that is, the grandchild’s parent). However, the trust would have an inclusion ratio of one and distributions to a beneficiary in a generation below the grandchild will trigger the GST tax.
status (so that the trust has an inclusion ratio of one). However, the GST rules applicable to
determine the identity of the transferor again should apply in determining whether a future
transfer (or termination of interest) triggers a GST tax.

6. **2642(c) Trusts**

Section 2642(c) provides a special rule for direct skips that are nontaxable gifts. In that case, the trust’s inclusion ratio is deemed to be zero without the use of the transferor’s
GST exemption. This rule applies to transfers in trust, but only if the trust meets specific criteria,
including that it benefit only one beneficiary during his or her lifetime and that the trust assets
must be includable in the beneficiary’s estate if the beneficiary dies during the trust term. Some
state decanting statutes prohibit the exercise of the decanting power if it would jeopardize the
trust’s qualification under Section 2642(c). If the trustee of the Distributing Trust may defeat the
beneficiary’s interest that gives rise to the special interest under Section 2642(c) (taking into
account the terms of the trust instrument, statutory law and common law principles), the trust
may not qualify under Section 2642(c).

**VII. CONCLUSION**

This Report proposes income, gift, estate and GST tax guidance applicable to trust
decantings. There are common elements that permeate the tax treatment. For example, for
income and gift tax purposes, we recommend that the decanting power generally be treated as a
form of distribution. Similarly, we recommend that the tax attributes of the Receiving Trust for
income, gift and GST tax purposes, such as the identity of the transferor, be measured by
reference to the Distributing Trust and that certain tax attributes of the Distributing Trust
continue with the Receiving Trust, except in limited circumstances. We further recommend that
exclusions, deductions and other favorable tax treatment, whether for income, gift, estate or GST
tax purposes, should not be affected by a decanting power unless it can be exercised in a fashion
that may defeat the rights which give rise the exclusion, deduction or other favorable tax
treatment.