Use of Trust Decanting to Extend the Term of Irrevocable Trusts

GST and gift tax consequences arise from using state statutes that permit trust decanting and a relaxed rule against perpetuities to extend the duration of irrevocable trusts.

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Recent developments in modern trust law have seen two major trends that seemingly coincide with a state’s reconsideration of its statutory trust code: the enactment of a trust decanting statute and the repeal of the common law rule against perpetuities. A trust decanting statute is coupled with a statutory repeal of the rule against perpetuities potentially provides a powerful mechanism to extend the term of irrevocable trusts. Currently, ten states have enacted trust decanting statutes:

1. Alaska.¹
2. Arizona.²
3. Delaware.³
4. Florida.⁴
5. Nevada.⁵
6. New Hampshire.⁶
7. New York.⁷
8. North Carolina.⁸
9. South Dakota.⁹
10. Tennessee.¹⁰

Four of these states—Tennessee, Florida, New Hampshire, and North Carolina—have adopted the Uniform Trust Code (UTC), and Arizona has adopted a modified version of the UTC.

In addition, nearly all of these states have either entirely repealed or substantially modified the common law rule against perpetuities to allow trusts of a perpetual or extended duration. Arizona, Delaware, New Hampshire, North Carolina, and South Dakota have repealed the common law rule against perpetuities and now permit trusts of a perpetual duration.¹¹ Alaska allows trusts to continue for 1,000 years, and Florida, Nevada, and Tennessee permit trusts lasting for a term of 360 or 365 years.¹² Therefore, in these states it may be possible to extend the life of irrevocable trusts beyond the term traditionally allowed by the common law rule against perpetuities.

Trust decanting overview

Trust decanting generally refers to the distribution of property from one trust to another trust pursuant to a trustee’s discretionary power to distribute property to or for the benefit of the trust’s beneficiaries. The rationale behind decanting is that if a trustee has the discretionary power to distribute property to or for the benefit of one or more beneficiaries, then the trustee has, in effect, a special power of appointment that should enable the trustee to distribute property to a second trust for the benefit of one or more of such beneficiaries.

In general, the holder of a special power of appointment may transfer any beneficial interest in property to objects of the power to the same extent as if the holder actually owned the beneficial interest in property.¹³ A power of appointment is characterized by the ability to transfer a beneficial interest in property the holder of the

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power does not otherwise possess, and thus a trustee’s discretion to distribute trust property to or among a class of beneficiaries may be characterized as a special power of appointment.\footnote{1} A trustee with discretionary power to distribute property to or for the benefit of one or more beneficiaries, moreover, should be able to give the current beneficiaries a special or general power of appointment under the terms of the second trust that would be the functional equivalent of distributing the property outright to the beneficiaries.\footnote{2} Of course, unlike the run-of-the-mill power of appointment, the trustee’s ability to decant trust property to another trust is subject to the trustee’s fiduciary duties to trust beneficiaries.\footnote{3}

Although the extent to which a trustee’s authority to decant trust property under common law may be unclear, an increasing number of state statutes have been enacted to expressly authorize a trustee’s power to decant trust property to another trust.\footnote{4} In addition, the terms of the trust instrument itself may expressly authorize a decanting.

In 1992, New York was the first state to enact a state “decanting” statute that allowed a trustee to appoint trust property in favor of another trust.\footnote{5} New York’s decanting statute was enacted with an eye towards extending the generation-skipping transfer (GST) tax exempt status of “grandfathered trusts,” trusts that are exempt from application of the GST tax because they were irrevocable on 9/25/1985, or otherwise qualify for exemption under certain transition rules.\footnote{6} Most commentators, however, take the view that the ability to extend the term of a grandfathered trust pursuant to the regulatory “safe harbors” is of limited utility.\footnote{7} An unresolved issue remains as to whether a post-effective date trust that is exempt from GST tax because sufficient GST tax exemption was allocated to cause the trust to have a zero-inclusion ratio (a “ZIR trust”) may be extended indefinitely without adverse GST or gift tax consequences.\footnote{8}

Extending the term of grandfathered trusts

The decanting issue has special implications for grandfathered trusts.

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\item \textbf{Exercise of a power of appointment.} The GST tax regulations do not treat the exercise of a special power of appointment contained in a grandfathered trust as a contribution of additional property that would taint grandfathered trust status so long as the power is not exercised in a manner that violates the permissible perpetuities period. This period generally is limited to lives in being plus 21 years or 90 years measured from the date of the grandfathered trust’s creation (the “federal perpetuities period”).\footnote{9}

For example, the exercise of a special power of appointment by appointing property further in trust would not subject transferees of grandfathered trust property to GST tax if the term of the continuing trust does not exceed beyond the federal perpetuities period.\footnote{10} However, if the exercise of the special power causes grandfathered trust property to continue in trust for a period that violates the federal perpetuities period, grandfathered trust property appointed in further trust would be treated as an addition to
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a trust that is no longer exempt from GST tax.\footnote{See Reg. 26.2601-1(b)(1)(v)(D), Example 5.}

Although state decanting statutes are premised on the underlying principle that a trustee’s discretionary authority to distribute property is equivalent to a special power of appointment, the regulations do not treat decantings from grandfathered trusts as the exercise of a special power of appointment for GST tax purposes.\footnote{See, e.g., N.Y. Est. Powers & Trusts Law § 10-6.6(f); Alaska Stat. § 13.36.157(c); Del. Code Ann. Tit. 12, § 3528(c); Fla. Stat. Ann. § 736.04117(3); N.C. Gen. Stat. § 36-8.816.1(d).} Instead, the regulations provide various “safe harbors” that govern whether distributions from or modifications of grandfathered trusts would cause a loss of GST exempt status.

**Regulatory “safe harbors.”** Despite the fact that the regulations contain no general rule providing what actions or modifications would result in a loss of a grandfathered trust’s exempt status, the regulations nevertheless provide certain safe harbors that apply to a decanting of property from grandfathered trusts.\footnote{Regs. 26.2601-1(b)(4)(i)(A) and 26.2601-1(b)(4)(i)(D).} For purposes of this article, the safe harbors that govern trust decantings will be referred to as “Safe Harbor #1” and “Safe Harbor #2.”

**Safe Harbor #1.** The first safe harbor governs discretionary distributions from grandfathered trusts taken pursuant to trustee action (Safe Harbor #1).\footnote{Reg. 26.2601-1(b)(4)(i)(A).} A trustee’s discretionary distribution of property from a grandfathered trust to a new trust, or retention of corpus in a continuing trust, does not cause the new or continuing trust to lose the grandfathered trust’s exempt status if the following three requirements are met:

1. Either the terms of the grandfathered trust or state law authorized the trustee’s action on the date the grandfathered trust became irrevocable.
2. The trustee’s action can be taken without beneficiary consent or court approval.
3. The new or continuing trust does not postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond the federal perpetuities period.\footnote{Id.}

Safe Harbor #1 may be available to extend a trust if the terms of the trust or state common law
authorized a trustee’s distribution of property further in trust on the date the trust became irrevocable. However, use of a state decanting statute to extend a grandfathered trust’s term would not satisfy the first requirement of Safe Harbor #1 because the first decanting statute was not enacted until 1992. Even assuming that a given state’s common law authorized a trust decanting on the date the trust became irrevocable, the term of the grandfathered trust cannot be extended indefinitely without violating the federal perpetuities period. It may be possible, however, to extend the term of a grandfathered trust to the limits of the federal perpetuities period under the terms of the trust or in states with favorable common law on trust decanting.

**Safe Harbor #2.** The second safe harbor applies to modifications of grandfathered trusts, a catch-all provision covering any changes to grandfathered trusts by trust decanting, court action, or otherwise (Safe Harbor #2). Any change to a grandfathered trust caused by a trust decanting must satisfy two requirements to meet Safe Harbor #2:

1. The modification must not shift a beneficial interest in the trust to any generation lower than that of the persons holding beneficial interests prior to the modification.
2. The modification must not extend the time for vesting of any beneficial interests beyond the period provided for under the terms of the grandfathered trust. Because the second requirement of Safe Harbor #2 prohibits the extension of time for vesting of any beneficial interest in a grandfathered trust, Safe Harbor #2 is unavailable to extend the term of a grandfathered trust.

The regulations provide that for purposes of Safe Harbor #2, a modification of a grandfathered trust results in a shift in beneficial interests to a lower-generation beneficiary if the modification can result in either (1) an increase in the GST transfer, or (2) the creation of a new GST transfer. Although the term “GST transfer” is not defined in the regulation, an example to the regulation illustrates that a modification of a grandfathered trust for the benefit of the settlor’s three grandchildren that increases the income payable to one of the grandchildren results in a shift in beneficial interests within generations, but does not impermissibly shift a beneficial interest to a lower generation.

**Consequences of losing grandfathered status.** The IRS has not definitively resolved the treatment of a grandfathered trust after a modification or extension of the trust’s term that violates the regulatory safe harbors and results in the trust’s loss of its GST tax-exempt status. Initially the IRS informally indicated that on the loss of a grandfathered trust’s exempt status, the current beneficiaries would be deemed to create a new trust in a transaction subject to the gift tax. The IRS later reconsidered its position and concluded that the settlor of a grandfathered trust would be treated as the transferor for GST tax purposes if the grandfathered trust lost its exempt status. Although whether and to what extent the settlor’s GST tax exemption would be applied to a trust losing grandfathered status remains unclear, most commentators feel that the loss of exempt status does not subject all future distributions from the trust to GST tax.

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28 See Reg. 26.2601-1(b)(4)(i)(E), Example 1 (providing an example of when a discretionary trust for a child and child’s issue that terminates on the death of the child would not lose grandfathered status if, pursuant to the terms of the governing instrument, property is distributed to another trust that continues during the life of the child’s issue).
29 For cases generally viewed as supporting a trustee’s common law authority to decant, see note 17, supra.
31 Id.
34 Reg. 26.2601-1(b)(4)(i)(E), Example 7 (providing example of modification that does not shift an interest to a lower generation).
35 Section 672(a).
36 Section 2013(e).
37 Ltr. Ruls. 9421048 and 9448024.
38 Ltr. Rul. 952032.
likely that distributions of grandfathered trust property would not be subject to the GST tax if the distributions would not qualify as generation-skipping transfers had the trust’s exempt status been ignored. However, distributions to beneficiaries who could not have received distributions free of GST tax from the grandfathered trust had the GST tax rules applied likely would be subject to GST tax.40

Extending the term of zero-inclusion ratio trusts
The discussion that follows focuses on issues that arise from extending the term of zero-inclusion ratio (ZIR) trusts.

Regulatory safe harbors. The regulatory safe harbors relating to grandfathered trusts, by their terms, do not apply to ZIR trusts that have been allocated sufficient GST tax exemption to cause the trust to have a zero-inclusion ratio. Private letter rulings, however, have extended the application of safe harbors to ZIR trusts by analogy. In the private letter rulings, the IRS acknowledges that no guidance has been issued on changes to trusts that may affect the exempt status of a ZIR trust, but concedes that, at a minimum, a modification that satisfies the grandfathered trust safe harbors would not affect the inclusion ratio of a ZIR trust.41 Therefore, it should be possible to extend the term of a ZIR trust pursuant to Safe Harbor #1, within the limits of the federal rule against perpetuities, if the terms of the trust or state law authorized the decanting at the time the trust became irrevocable.

Extending ZIR trust terms outside of the safe harbors. Additionally, it may be possible to extend the term of a ZIR trust beyond the federal rule against perpetuities applicable to grandfathered trusts by decanting trust property to a valid perpetual or dynasty trust under applicable state law, even if the perpetual extension of the trust’s term would violate Safe Harbor #1.42 As mentioned above, the regulatory “safe harbors” expressly apply only to grandfathered trusts, and do not extend to ZIR trusts.

A ZIR trust differs from a grandfathered trust in that a ZIR trust is exempt from GST tax because sufficient GST tax exemption was allocated to the trust to produce a zero inclusion ratio, whereas a grandfathered trust is exempt from GST tax pursuant to the effective date rules set forth in the regulations. In the absence of statutory or regulatory guidance on the GST tax consequences of extending ZIR trusts, a trust decanting that extends the term of a ZIR trust could be analyzed under the rules governing the exercise of special powers of appointment.

Prior to the regulatory amendments issued on 5/20/1997, the regulations provided that the exercise of a special power of appointment in a non-grandfathered trust that extended a trust’s term beyond the federal perpetuities period would be treated as a transfer subject to federal gift and estate tax,
and the powerholder would be the deemed transferor of the trust after exercise of the special power. The intent of the regulation was to subject the extension of a ZIR trust pursuant to a special power of appointment to the GST tax, although tax would not have applied otherwise. However, a regulatory amendment deleted the section after it was perceived as an abuse to extend the term of trust with an inclusion ratio of one beyond the applicable perpetuities period and shift the identity of the transferor to the powerholder’s generation tax-free.

Because this provision has been deleted from the regulations, it should be possible to extend the term of a ZIR trust through the exercise of a special power of appointment without adverse GST tax consequences. Care must be taken, however, to ensure that the extension does not violate Sections 2041(a)(3) and 2041(d), commonly known as the “Delaware tax trap” (discussed below). The Delaware tax trap could be avoided by providing that the second trust cannot be extended for a period determined without reference to the creation of the first power in the original trust.

Consequently, it also should be possible to extend the term of a ZIR trust indefinitely through trust decanting by analogizing the trustee’s power to distribute to a special power of appointment. Although it is currently unclear whether the treatment of a trustee’s discretionary distribution power as a special power of appointment for GST tax purposes would be determined under state law or as-of-yet-delineated federal common law, nearly every state decanting statute specifically treats the trustee’s power to decant as the exercise of a special power of appointment.

Unlike the GST tax regulations governing grandfathered trusts, which treat a trustee’s discretionary power to distribute differently from the exercise of a special power of appointment, the definition of a “power of appointment” under the estate and gift tax regulations is broad enough to include a trustee’s fiduciary power to distribute trust property. The gift and estate tax regulations define a power of appointment as “all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations.” A fiduciary power over the management or administration of trust assets is not considered a power of appointment if the holder has no power “to enlarge or shift any of the beneficial interests” in trust, excepting those powers that incidentally affect beneficial interests as a consequence of discharging the trustee’s fiduciary duties.

This definition implies that a fiduciary power that would enable the holder to enlarge or shift any of the beneficial interests in a trust, such as a discretionary power to distribute trust income or principal to some, none, or all of a trust’s beneficiaries, would satisfy the definition of a power of appointment. Because the defining feature of a power of appointment for gift and estate tax purposes appears to be the ability to affect substantially the enjoyment of beneficial interests in trust property, by analogy a trustee’s power to decant trust property should be treated as a power of appointment for GST tax purposes. In the absence of statutory or regulatory guidance that explicitly provide special rules governing decantings of property from nongrandfathered trusts, it should be possible to extend the term of a ZIR trust to the fullest extent of the perpetuities period allowed under applicable state law.

**Inclusion ratio resulting from a decanting.** The qualified severance statute, Section 2642(a)(3), and corresponding regulations provide guidance on when multiple trusts resulting from the division of a single trust would be treated as separate trusts for GST tax purposes. The qualified severance statute was temporarily added by the Economic Growth and Tax Relief Reconciliation Act of 2001 and currently is set to sunset after 2010. A “qualified severance” occurs if:

1. A single trust is divided on a fractional basis.
2. The terms of the trusts resulting from the division provide, in the aggregate, for the same succession of beneficial interests as provided in the original trust.

A qualified severance of a ZIR trust results in each separate trust having an inclusion ratio equal to zero.

If a trust authorizes discretionary distributions to beneficiaries on a non-pro rata basis, then separate...
trusts will not provide for the same succession of beneficial interests within the meaning of Section 2642(a)(3) unless:

1. The terms of the trusts are the same as the original trust (although the beneficiaries of the original trust do not have to be beneficiaries of all resulting trusts).

2. Each beneficiary’s interest in the resulting trusts collectively equals the beneficiary’s interest either under the terms of the original trust or, if not provided for in the original trust, on a per capita basis.

3. The severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation.

4. The severance does not extend the time for vesting of any beneficial interest beyond the period provided for in, or applicable to, the original trust.53

It is therefore unlikely that an extension of a ZIR trust’s term pursuant to a trust decanting would satisfy the qualified severance requirements where the decanting resulted in a single trust that extended beyond the terms of the original trust. A decanting that validly extends the term of a ZIR trust under applicable state law, however, arguably would retain the zero-inclusion ratio of the original trust and be treated as a continuation of the original trust.54 With respect to a ZIR trust that is divided into multiple trusts, the regulations provide that if a nongrandfathered trust is divided into one or more multiple trusts pursuant to a nonqualified severance, the resulting trust would have the same inclusion ratio as the original trust and be recognized as a separate trust for GST tax purposes if the division is recognized under state law.55 Therefore, a valid division of a ZIR trust into more than one separate trust under state law should cause each trust resulting from the division to have a zero-inclusion ratio, even if the terms of the separate trusts extend beyond that provided in the original trust.

Delaware tax trap
In addition to changes to a trust’s inclusion ratio, an additional consideration is whether a trust decanting that extends the term of a ZIR trust could result in taxable gift by violating Section 2514(d), also known in conjunction with Section 2041(a)(3) as the “Delaware tax trap.”56 Section 2014(d) is an arcane statute that, as a practical matter, easily may be avoided by careful drafting or by state legislation. As further discussed below, the vast majority of the states with decanting statutes in force have enacted legislation that generally makes application of Section 2514(d) a non-issue. Section 2514(d), however, may pose a trap for the unwary estate planning practitioner when a trust decanting is performed pursuant to the terms of the trust instrument or inartfully drafted decanting legislation.

Section 2514(d) provides that the exercise of a power of appointment is deemed a transfer of property by the powerholder if:

(1) The power of appointment was created after October 21, 1942; and

(2) The power is exercised by creating another power of appointment which, under applicable state law, could be validly exercised to:
   (a) postpone the vesting of any estate or interest in the property subject to the first power for a period ascertainable without regard to the date of creation of the first power; or
   (b) suspend the absolute ownership or power of alienation of property subject to the first power for a period ascertainable without regard to the date of creation of the first power.57

If Section 2514(d) is violated, the powerholder is deemed to transfer the property subject to the power of appointment created by the exercise of the first power.58 The regulations suggest that the determination of whether an invalid postponement or suspension occurs depends on whether the rule against perpetuities under applicable local law is stated in terms of vesting or the power of alienation.59 Therefore, the postponement-of-vesting branch applies if the applicable rule against perpetuities is based on a rule against remoteness of vesting, and the suspension-of-absolute-ownership or power-of-alienation branch applies where the applicable perpetuities period is stated in terms of suspension of ownership or power of alienation.60

The definition of a power of appointment contained in the gift tax regulations appears broad enough to include an independent trustee’s discretionary power to distribute property if the trustee could exercise the power in a manner that would substantially shift beneficial interests in the trust. All of the state decanting statutes premise a trustee’s ability to distribute property further in trust on the trustee’s

54 See, e.g., Ltr. Rul. 200832020 (modification by trustees to divide and change administrative provisions of trust authorized under state law was treated as a continuation of the trust for federal income tax purposes); Ltr. Rul. 9330008 (extension of a trust resulting from the exercise of a special power of appointment granted in the grandfathered trust was treated as a continuation of the grandfathered trust).
55 Reg. 26.2642-6(h).
57 Section 2514(d).
58 Ibid.
59 Reg. 25.2514-3(d).
60 Ibid.; see also also Estate of Murphy, 71 TC 671 (1979) (discussing intent of Section 2041(a)(3) and development of state perpetuities law in terms of vesting or alienation).
discretionary power to distribute property under the trust instrument. The overwhelming majority of these decanting statutes, moreover, expressly characterize a decanting by the trustee as the exercise of a special power of appointment. Therefore, a decanting of trust property pursuant to state statute, common law, or the trust instrument that validly extends the term of a trust under state law potentially could violate the provisions of Section 2514(d) and result in a transfer of property by the trustee for gift tax purposes. It may be possible, however, for a decanting by an independent trustee that validly extends the term of a trust to avoid application of Section 2514(d) for either of two reasons:

1. The decanting does not create a power that may be exercised so as to postpone the vesting or suspend the absolute ownership or power of alienation of an interest in trust property for a period ascertainable without regard to the date of the creation of the trustee’s discretionary distribution power.

2. A decanting by an independent trustee does not result in a “gift” for purposes of the gift tax.

Suspension or postponement of vesting or alienation. If a trustee’s discretionary power to make distributions is viewed as a power of appointment, a trust decanting could create a power that may be exercised to postpone or suspend the vesting of interests in, or power of alienation over, trust property where the new trust authorizes discretionary distributions to beneficiaries for a period beyond that authorized in the original trust. A trust decanting could also postpone or suspend the vesting or alienation of property if the new trust creates new powers of appointment that can be exercised to extend the duration of the trust. To violate Section 2514(d), however, the potential to postpone or suspend the vesting or alienation of property in the second trust must be made without regard to the date of creation of the trustee’s discretionary power in the first trust.

To help protect against a potential violation of Section 2514(d), nearly all of the state decanting statutes have been drafted to require that the permissible period for the postponement of vesting of interests in trust property or, if the state’s perpetuities rule is stated in terms of alienation, the suspension of power of alienation over trust property pursuant to a trustee’s decanting power, must be determined by reference to the date of creation of the original power of appointment. The Tax Court examined this issue in Estate of Murphy, and ultimately held that property subject to a power of appointment was not included in the power holder’s estate under Section 2041(a)(3), the estate tax counterpart to Section 2514(d), where, under applicable local law, the permissible perpetuities period of a power of appointment created through the exercise of a special power is computed from the special power’s creation, and not its subsequent exercise. The facts of Murphy were as follows: Under a trust established by her father, the decedent was given a special testamentary power of appointment over trust property if the decedent died before termination of the trust. In her will, the decedent exercised the power by appointing trust property to a family trust established for the benefit of the decedent’s spouse and issue under the terms of the will. The family trust gave the decedent’s spouse a special testamentary power to appoint the trust property “as he may see fit.”

Under Wisconsin law, the law governing the decedent’s exercise of the special power of appointment, the permissible perpetuities period governing the exercise of a special power of appointment to create a new power ran from the creation of the first power, and not its exercise. As a result, Section 2041(a)(3) did not apply to include property subject to the decedent’s special power of appointment in her estate, because under applicable local law the perpetuities period of the newly created power could not be computed without regard to the date of the creation of the first power. Wisconsin’s statutory rule against perpetuities, however, stated the permissible perpetuities period solely in terms of the power of alienation, and provided that an interest in

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41 See Alaska Stat. § 13.36.157(a)(3); Del. Code Ann. Tit. 12, § 3528(b); Del. Code Ann. Tit. 25, § 504, but cfr. Del. Code Ann. Tit. 25, § 501 (providing that estate or interest in property created through exercise of power of appointment shall be deemed created at the time of the exercise of the power for purposes of any rule against perpetuities, remoteness of vesting, or restraint on power of alienation, or accumulations); Fla. Stat. § 736.04117(3); N.Y. Est. Powers & Trusts Law § 10-6.6(f); N.C. Gen. Stat. § 36-8-816.1(c)(8); (d); and 41-23(c); S.D. Codified Law §§ 43-5-5 and 55-2-20; Tenn. Code Ann. § 35-15-816(27)(C); see also Estate of Murphy, supra note 60 (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).

Note 60 supra.
property is void only if it suspends the power of alienation for longer than lives in being, plus 30 years. The statute additionally provided that the power of alienation over trust property is not suspended if the trustee has the power to sell the property. Wisconsin law did not prohibit remoteness of vesting so long as the statutory prohibition against suspension of the power of alienation was not violated.

The IRS took the position that Section 2041(a)(3) required that property subject to a power of appointment be included in the power holder’s estate if the exercise of the power violated any of three statutory conditions:

1. Postponement of vesting.
2. Suspension of absolute ownership of property.
3. Suspension of the power of alienation.

Considering that Wisconsin’s perpetuities law referred to only the suspension of the power of alienation, the IRS argued that the decedent’s exercise of the special power of appointment violated Section 2041(a)(3) because it could be validly exercised to postpone indefinitely the vesting of any interest in the property.

In determining whether the decedent’s exercise of the testamentary special power of appointment violated Section 2041(a)(3), the Tax Court analyzed the common law treatment of the rule against perpetuities that was “so inextricably a part of section 2041(a)(3).” The court noted that the common law rule against perpetuities could be stated in two ways, either in terms of remoteness of vesting, or in terms of suspension of the power of alienation. The prohibition against remoteness of vesting has become the more commonly viewed form of the rule, which generally provides that a future interest is void unless it must vest or fail within lives in being plus 21 years. The more historic version of the rule against perpetuities, however, prohibits the suspension of the power of alienation, which exists when there are no persons in being who can collectively transfer complete ownership of property.

The court concluded that the statutory requirements concerning the postponement of vesting or the suspension of absolute ownership or power of alienation of property depended on the nature of the rule against perpetuities applied in a particular jurisdiction, whether stated in terms of vesting, alienation, or absolute ownership of property. The court noted that, although a literal reading of Section 2041(a)(3) required that all three conditions be met, the applicable regulations and legislative history indicated that Congress intended for the statute to cover the rule against perpetuities as formulated under the law of the various states. In rejecting the IRS’s argument that all three requirements apply to every exercise of a power of appointment regardless of its validity under the perpetuities law of the applicable jurisdiction, the court stated that “[t]his interpretation of section 2041(a)(3) would ignore the evolution of the Rule throughout the various States and extend its reach well beyond that intended by Congress.”

Extension of the court’s analysis in Murphy indicates that, to avoid application of Section 2514(d), the permissible perpetuities period, as expressed under applicable state law, of a new power created by the exercise of a special power of appointment must be measured from the date of creation of the first power. Although it might not be necessary for a given trust decanting to satisfy all three statutory conditions as to vesting, alienation, or absolute ownership of property, it may be advisable to include a provision that addresses all three situations given the increased mobility of trusts. The simplest way to avoid application of Section 2514(d) may be to track the language of the statute in the terms of the governing instrument. Nevertheless, practitioners should be advised to research the validity of the provision in light of the law of a particular jurisdiction.

As a result, it may be possible to distribute property to another trust of perpetual duration in Delaware.⁶⁴

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⁶⁴ See Del. Code Ann. Tit. 12, § 3528(c). Del. Code Ann. Tit. 25, § 503, 504, and 254 Del. Laws 2008. It should be noted, however, that Delaware law provides that “[t]he duration of a trust and time of vesting of interests in the trust property shall not change merely because the place of administration of the trust is changed from some other jurisdiction to this State.” Del. Code Ann. Tit. 12, § 3332(a).
North Carolina,\textsuperscript{65} and South Dakota\textsuperscript{66} pursuant to a trust decanting without violating Section 2514(d), so long as the terms of the trust otherwise satisfy the statutory requirements relating to valid perpetual trusts. In these three states, the repeal of the traditional common law rule against perpetuities based on remoteness of vesting applies retroactively to trusts created before the repeal’s enactment.\textsuperscript{67} Therefore, it may be possible to extend indefinitely the term of a trust created prior to the repeal that originally was limited to the traditional common law rule against perpetuities, even if the new perpetuities period is measured from the time of the trust’s creation.

Similarly, it may be possible to extend trusts created in Alaska for 1,000 years through a trust decanting, or in Florida for a term of 360 years, measured as of the date of the original trust’s creation.\textsuperscript{68} Despite the protection built into the state decanting statutes, it would be advisable to include a clause in the decanting resolution or the extended trust that provides that postponement of vesting of beneficial interests in, or suspension of absolute ownership or power of alienation over, trust property cannot be extended through the trustee’s discretionary distribution power or the exercise of a special power of appointment for a period in excess of the governing permissible perpetuities period.

**Planning Tip**

The view has been expressed that the Delaware tax trap would be violated if a new power of appointment were created in a state with a perpetual perpetuities period, because there would be no finite period of time within which the property interest must vest or become fully alienable. See, e.g., Greer, The Alaska Dynasty Trust, 18 Alaska L. Rev. 253, 277 (2001). However, the states that allow trusts of a perpetual duration also limit the duration of trusts if certain requirements are not met and, therefore, provide multiple perpetuities periods: one that is indefinite, and another that is limited to a finite period. For example, Delaware allows trusts to hold personal property indefinitely, but a 110-year limitation is placed on real property. Del. Code Ann. Tit. 25, § 503(a), (b). North Carolina repealed the common law rule against perpetuities based on vesting in favor of an alienation rule that voids a trust that suspends the power of alienation over trust property for longer than 21 years plus lives in being, but permits a perpetual trust under certain circumstances, for example, if the trustee has the power to sell the property. N.C. Gen. St. § 41-23(a), (e).

**Decanting as a transfer by gift.**

Assuming that a trust decanting is performed in a manner that violates Section 2514(d), it would not necessarily follow that the trustee has made a taxable gift. As a general matter, the gift tax is imposed on: (1) the transfer; (2) of property; (3) by gift.\textsuperscript{69} Under a plain reading of the statute, a decanting by a trustee that violates Section 2514(d) is deemed to be “a transfer of property,” thus satisfying the first two elements required for the imposition of the gift tax. Section 2514(d), however, does not explicitly provide that the deemed transfer of property is also a deemed gift.

No cases construe or interpret Section 2514(d), but it is arguable that a trust decanting that otherwise violates Section 2514(d) would not result in a taxable gift where the trustee possesses no beneficial interest in the property subject to the decanting. (Court decisions and informal rulings by the IRS have only considered the inclusion of property in a power holder’s estate under Section 2041(a)(3) where the power holder had a beneficial interest in the property subject to a testamentary power of appointment.\textsuperscript{70}) The regulations provide that a gift subject to tax results from “any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed.”\textsuperscript{71}

Although donative intent is not an essential element for a transfer to be subject to gift tax, the regu-
lations clarify that the gift tax is inapplicable to certain types of transfers and that “[a] transfer by a trustee of property in which he has no beneficial interest does not constitute a gift by the trustee.”

Therefore, a decanting by an independent trustee with no beneficial interest in the trust property should not result in a taxable gift. For example, no gift would result from a trustee’s discretionary distribution of property to beneficiaries where the trustee had no beneficial interest in the distributed property. Similarly, the distribution of trust property to another trust pursuant to a trustee’s power to decant should not result in a taxable gift if the trustee had no beneficial interest in the property and the decanting is undertaken in furtherance of the trust’s fiduciary duties to the trust and its beneficiaries.

In contrast, the regulations provide that a gift may occur if a trustee with a beneficial interest in trust property makes a discretionary distribution, unless distributions by the trustee are limited by an ascertainable standard under the governing instrument. However, if a beneficiary-trustee participates in a decanting of property to a trust with an extended term, a taxable gift may result under Section 2511(a), without regard to Section 2514(d), if the decanting eliminates or otherwise reduces the trustee’s beneficial interest in the trust. For example, if a beneficiary-trustee participates in a trust decanting that extends the term of a trust or eliminates the trustee’s discretionary life income interest in the property, then the decanting may result in a taxable gift by the trustee.

Similarly, if the trustee is a contingent remainder beneficiary of trust property, a taxable gift could result under Section 2511(a) if the trustee decants property to another trust with an extended term that eliminates or decreases the trustee’s contingent remainder interest in the property. The value of the gift under Section 2511(a), however, would be limited to the value of the interested beneficiary-trustee’s interest that was eliminated or reduced by the decanting.

In the absence of an elimination or reduction in a trustee’s beneficial interest, for example, where a beneficiary-trustee’s interest in a trust remains the same before and after the decanting, it would appear that a decanting would not result in a taxable gift under Section 2511(a), but a taxable gift may occur if the transfer falls within the terms of Section 2514(d) and the mere fact of the trustee’s beneficial interest is enough to subject the transfer to gift taxation. It is possible that the IRS would take this position and argue that where a beneficiary-trustee decants property to another trust, the trustee is treated as making a gift of the entire value of property subject to a new power of appointment created under the terms of the second trust in violation of Section 2514(d).

Conflict of laws governing trust decantings
Practitioners should be aware of any conflict of law principles involved with a decanting that extends the term of a trust. Both the Restatement (Second) of Conflict of Laws (the “Restatement 2d Conflicts”) and the U.T.C. support the general proposition that the terms of a trust may designate the law of a jurisdiction to govern matters concerning the trust or the trust’s administration so long as the jurisdiction has some connection of particular significance to the trust.

The Restatement 2d Conflicts and the U.T.C. recognize that the law designated in the terms of a trust may not be respected where the law is contrary to the strong public policy of the state having the most significant relationship to the trust matter at issue. Property decanted to a trust whose governing law permits an extended perpetuities period potentially could raise the issue of whether application of the new per-
possible perpetuities period would violate the strong public policy of the state with the most significant relationship to the trust.

As such, practitioners would be well advised to determine the policy of the state having the most significant relationship to the trust with respect to any perpetuities issue. The Restatement 2d Conflicts lists several factors indicating that a state has a substantial relation to a trust, such as:

- Whether the state was designated as the trust’s place of administration by the settlor.
- Whether the state was the place of business or domicil of the trustee, the state of domicil of the settlor, or the location of trust assets, at the time of the trust’s creation.
- Whether the state was the domicil of the beneficiaries.80

The Restatement 2d Conflicts further recognizes that “there may be other contacts or groupings of contacts which will likewise suffice.”81

Practitioners should consider not only the public policy of the state with the most significant relationship to the trust, but also the law of the state governing the permissible perpetuities period after a trust decanting. For example, South Dakota’s decanting statute provides that the decanting may not “suspend the power to alienate trust property or extend the first trust beyond any applicable termination date under the terms of the instrument of the first trust or the permissible period of any rule against perpetuities applicable to the first trust.”82 It is unclear, however, whether this limitation applies only to a trust decanting taken pursuant to South Dakota’s decanting statute. Also, Delaware law provides that “[t]he duration of a trust and time of vesting of interests in trust property shall not change merely because the place of administration of the trust is changed from some other jurisdiction to this State,”83 which implies that a trust will not be governed by Delaware’s perpetuities law unless the trust’s connection to the state involves something more than a mere change to its place of administration.

The effective date and applicability of a state’s repeal of the common law rule against perpetuities also should be thoroughly investigated before property is decanted to a trust intended to be governed by the perpetuities law of that jurisdiction. Similarly, practitioners should consider the permissible perpetuities period applicable to particular types of property decanted to another trust. For example, the Restatement 2d Conflicts takes the position that beneficial interests in real property held in trust are governed by the law of the property’s situs.84 Therefore, although personal property potentially could be decanted to a trust of perpetual duration, real property decanted to such a trust may remain subject to the permissible perpetuities period or the jurisdiction in which the property is located. It should be possible to avoid a more restrictive perpetuities period applicable to real property held in trust by holding equitable interests in corporations or limited liability companies that own real property, where the equitable interests are treated as personal property under state law.

Conclusion

Although the consequences of extending the duration of an irrevocable trust by means of trust decanting are as of yet unresolved, in the absence of statutory or regulatory guidance to the contrary, a good argument can be made that the term of a trust may be validly extended without adverse GST and gift tax consequences. The unresolved issues regarding the change, if any, to a ZIR trust’s inclusion ratio as a result of extending the trust’s term beyond that originally provided for in the trust instrument raises a host of questions, including:

1. The method to determine the ZIR trust’s new inclusion ratio.
2. The identity of the person treated as the transferor for GST tax purposes.
3. The manner and extent to which the initial deemed transferor’s GST tax exemption would apply.

Until further guidance on these issues has been provided, it is arguable that the extension of a ZIR trust’s term by means of a trust decanting should not alter the zero-inclusion ratio of a trust validly extended under the terms of the trust instrument or state law.

As a practical matter, gift taxation of trust decantings that extend the duration of an irrevocable trust in violation of Section 2514(d) would raise various challenging issues. In light of the dearth of guidance on the reach and effect of Section 2514(d), it is important that a trustee be satisfied that a decanting avoids application of the section before exercising the trustee’s power to decant. ■

80 Restatement (Second) of Conflict of Laws: Trusts § 270 cmt. b (1971).
81 Id.
82 S.D. Codified Law § 55-2-20.
84 See, e.g., Restatement (Second) of Conflict of Laws: Trusts § 270 (1971).