TRUST DECANTING: AN OVERVIEW AND INTRODUCTION TO CREATIVE PLANNING OPPORTUNITIES

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Editors' Synopsis: Since New York enacted the first "trust decanting" statute in 1992, nine other states likewise have provided trustees authority to "decant" the property of one trust into another trust. In this Article, the authors provide an overview of the techniques involved with the decanting process and the opportunities these statutes provide trustees.

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I. INTRODUCTION TO DECANTING

Decanting is the term generally used to describe the distribution of trust property to another trust pursuant to the trustee's discretionary authority to make distributions to, or for the benefit of, one or more beneficiaries. Potentially, common law provides authority for decanting, but a state statute or the terms of the trust instrument may expressly authorize a trustee to decant trust property to another trust. Trustees may decant to achieve a variety of favorable tax or nontax results or to address changes in state law or in other circumstances affecting management or administration of the trust after it has become irrevocable.

The rationale that underlies decanting is that if a trustee has the discretionary power to distribute property to, or for the benefit of, one or more current beneficiaries, then the trustee, in effect, has a special power of appointment that should enable the trustee to distribute the property to a second trust for the benefit of such beneficiaries. The trustee, moreover, should be able to give the current beneficiaries a special or general power of appointment under the terms of the second trust, the latter of which would be the functional equivalent of distributing the property outright to the beneficiaries. This view is in accord with the treatment of a trustee's discretionary power to distribute as a special power of appointment under the *Restatement (Second) of Property: Donative Transfers* (the *Second Restatement*) and the *Restatement (Third) of Property: Wills & Other Donative Transfers* (the *Third Restatement*),[1] although the *Third Restatement* additionally highlights the fact that, unlike a run-of-the-mill special power of appointment, fiduciary standards are imposed on a trustee's discretionary distribution power.[2]

In 1992, New York was the first state to enact a decanting statute allowing a trustee to appoint trust property in favor of another trust.[3] As of the date of this Article, nine other states—Alaska, Tennessee, Delaware, South Dakota, Florida, New Hampshire, North Carolina, Arizona, and Nevada—also had passed decanting statutes.[4] Although New York enacted its statute with an eye towards extending the generation-skipping transfer (GST) tax exempt status of grandfathered trusts, practitioners have used decanting statutes to achieve a variety of favorable tax and nontax results.[5]

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[1] *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS §§ 11.1 cmt. a, 19.3 cmt. a, illus. 1, 19.4 (1986); RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 19.14 (Tentative Draft No. 5, 2006).

[2] *See* RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 cmt. g (Tentative Draft No. 5, 2006).

[3] *See* N.Y. EST. POWERS & TRUSTS LAW. § 10-6.6(b) (McKinney 2002).

[4] ALASKA STAT. § 13.36.157 (2008); ARIZ. REV. STAT. ANN. § 14-10819 (2005); DEL. CODE ANN. tit. 12, § 3528 (2007); FLA. STAT. ANN. § 736.04117(1)(a) (West Supp. 2008); 2009 Nev. Stat. 782 (enacting trust decanting provision in Chapter 163 of the Nevada Revised Statutes); N.H. REV. STAT. ANN. § 564-B:4-418 (LexisNexis Supp. 2009); N.C. GEN. STAT. § 36C-8-816 (2009); S.D. CODIFIED LAWS § 55-2-15 (Supp. 2008); TENN. CODE ANN. § 35-15-816(27) (2007). Four of these nine states—Tennessee, Florida, New Hampshire, and North Carolina—have adopted the Uniform Trust Code (U.T.C.), and Arizona has adopted a modified version of the U.T.C.

[5] *See* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b) (McKinney 2002).

II. DECANTING UNDER COMMON LAW

A trustee's ability to decant is uncertain under the common law of a majority of the states, but the *Second* and *Third Restatements* and relevant case law in at least three states recognize a trustee's power to appoint trust property in further trust pursuant to a discretionary distribution power.[6]

A. Restatement of Property

The *Second* and *Third Restatements* indicate that a trustee's ability to distribute trust property to a beneficiary includes the ability to transfer property to a trust for that beneficiary's benefit. The *Second Restatement* takes the position that the trustee's ability to transfer trust property is similar to a special power of appointment, under which a trustee can transfer an interest in property equal to or less than the title authorized under the trust instrument.[7] If the trustee is able to transfer full legal title to trust property to a beneficiary, the trustee should be able to transfer less than full legal title by transferring the property further in trust.

1. Restatement (Second) of Property: Donative Transfers

The *Second Restatement* provides that "[a] power of appointment is authority, other than as an incident of the beneficial ownership of property, to designate recipients of beneficial interests in property."[8] When a beneficial owner of property has the ability to transfer rights associated with the ownership interest, the power to transfer the interest in property is incident to ownership of the interest, and the beneficial owner is the direct transferor of the property.[9] In contrast, a power of appointment permits persons to transfer a beneficial interest in property they do not otherwise possess, and the exercise of the power is considered the completion of a transfer originating with the creator of the power.[10] Therefore, the power to determine the identity of persons entitled to receive beneficial interests in property that are owned by persons other than the "powerholder" characterizes a power of

[6] *See infra* Part II.A–B.

[7] *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 cmt. d (1986). As discussed below, a majority of the state decanting statutes treat a trustee's discretionary authority to appoint trust property in further trust as the exercise of a special power of appointment. *See, e.g.*, ALASKA STAT. § 13.36.157(c) (2008); DEL. CODE ANN. tit. 12, § 3528(c) (2007); FLA. STAT. ANN. § 736.04117(3) (West Supp. 2008); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(f) (McKinney 2002).

[8] RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 (1986).

[9] *See id.* cmt. b.

[10] *See id.*

appointment.[11] The exercise of a power of appointment divests title to beneficial interests in property from those otherwise entitled to such interests in default of exercise of the power.[12] In this respect, the power to amend, revoke, or terminate a transfer of property in whole or in part constitutes a power of appointment.[13]

Because a power of appointment depends on the nature of the right to transfer beneficial interests in property and not the capacity in which the power is held, the powerholder may hold a power of appointment in either a fiduciary or nonfiduciary capacity, as long as the powerholder does not possess the beneficial interest in property that may be transferred pursuant to the power.[14] Thus, the *Second Restatement* characterizes a trustee's discretion to pay trust property to a beneficiary or among a class of beneficiaries as a power of appointment because the trustee is authorized to determine the recipients of beneficial interests in property that the trustee does not possess otherwise.[15]

The *Second Restatement* indicates that, unless the donor manifests a contrary intent, a powerholder may transfer any beneficial interest in property to objects of the power only to the same extent as if the powerholder actually owned the beneficial interest in property.[16] For example, rather than transferring all or part of an interest in property outright to a proper object, or "permissible appointee," of the power, the powerholder could transfer the property in trust and direct the trustee to distribute all income to a permissible appointee for life, then distribute the remaining trust property outright to another permissible appointee.[17] The *Second Restatement* reasons that although the powerholder transfers legal title to a person that is not a permissible appointee, the powerholder nevertheless has transferred beneficial interests in property to those who are proper objects of the power.[18]

The *Second Restatement* indicates that if a powerholder may transfer property outright to a permissible appointee, the creation of a testamentary general power in the permissible appointee is, "in substance, the equivalent of a permissible outright appointment" of trust property, especially if the permissible appointee has a life income interest in the appointive assets.[19]

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[11] *See id.* cmt. a.
[12] *See id.* cmt. e.
[13] *See id.* cmt. c.
[14] *See id.* cmt. a.
[15] *See id.* cmt. d.
[16] *See id.* § 19.3.
[17] *See id.* cmt. a., illus. 1.
[18] *See id.*
[19] *Id.* § 19.4 (special powerholder's creation of power of appointment in another).

The *Second Restatement* also authorizes a powerholder to create a new special power of appointment in any other person, which is exercisable only in favor of permissible appointees of the original power.[20] Coupled with the power to appoint further in trust, the trustee's discretionary distribution power should authorize a trustee to create new powers of appointment in trust beneficiaries.[21] For example, a trustee with the discretionary power to distribute trust property outright to, or for the benefit of, one or more trust beneficiaries should be able to distribute property to a separate discretionary trust for the benefit of one beneficiary for life that gives the beneficiary a special power of appointment over the appointed trust assets.

2. Restatement (Third) of Property: Wills & Other Donative Transfers

The *Third Restatement* (a tentative draft that the American Law Institute has not yet reviewed or accepted) expressly provides that the holder of a special power of appointment may exercise the power by appointing property to a trust solely for the benefit of permissible appointees of the power.[22] Unless the creator of the power expressly prohibits an appointment of property in trust, the holder of a special power has the authority to exercise the power in favor of permissible appointees by appointing property further in trust.[23]

The *Third Restatement*, however, defines a power of appointment as a power granted to a holder acting in a nonfiduciary capacity.[24] The *Third Restatement* distinguishes between powers of appointment and fiduciary distributive powers based on the different treatment afforded the powers: (1) fiduciary standards are imposed on the exercise of a power held in a fiduciary capacity, but a power of appointment may be exercised arbitrarily; and (2) a fiduciary power survives the death of a fiduciary and succeeds to the successor fiduciary, but a power of appointment is personal to the powerholder and lapses if not exercised.[25] Nevertheless, the *Third Restatement* recognizes that a fiduciary distributive power is subject to the same general rules regarding special powers of appointment, such as the requirement that the power be exercised in favor of permissible appointees, and it may be subject to the same common law or statutory rules relating to perpetuities

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[20] *See id.*

[21] *See id.* cmt. b.

[22] *See* RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 19.14 (Tentative Draft No. 5, 2006).

[23] *See id.* cmt. d.

[24] *See id.* § 17.1.

[25] *See id.* cmt. g.

otherwise applicable to special powers of appointment.[26] Therefore, although the *Third Restatement* expressly excludes fiduciary distributive powers from the definition of powers of appointment because of the fiduciary nature of the power, the same general rules applicable to special powers of appointment, including the power to appoint trust property further in trust, should apply to trustees acting within their fiduciary discretion.

Although the examples given in both the *Second* and *Third Restatements* generally involve holders that were not acting in a fiduciary capacity while exercising powers of appointment, it seems clear that a power of appointment would authorize a trustee to exercise the power to the same extent as it would a nonfiduciary, subject to the fiduciary duties a trustee otherwise owes to the trust's beneficiaries. Of course, a trustee's discretionary authority to make distributions differs from a nonfiduciary's power of appointment. The trustee owes fiduciary duties to the permissible appointees of its power (the trust beneficiaries) but owes no obligations or standards of care on the exercise of a power held in a nonfiduciary capacity.[27]

B. Case Law

Courts in at least three states have considered whether and to what extent the common law permits a trustee to appoint trust property in favor of another trust. These cases generally analyze the power to appoint in trust as a special power of appointment and apply general rules governing the exercise of such a power.

1. Florida: Phipps v. Palm Beach Trust Co.

In *Phipps v. Palm Beach Trust Co.*,[28] the Supreme Court of Florida considered whether a trustee, authorized to direct distributions of trust property to trust beneficiaries in his sole discretion, could create a second trust for the benefit of the beneficiaries funded with property distributed from the first trust. In *Phipps*, the settlor established a trust for the benefit of her children and her children's descendants, naming her husband as individual trustee and a trust company as the corporate trustee.[29] Pursuant to the trust instrument, the individual trustee and his successors had the power in their "sole and absolute discretion" to direct distributions of some, none, or all of

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[26] *See id.*

[27] *See* RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. a (2003). A trustee may hold a power of appointment in a nonfiduciary capacity, although powers that run with a trusteeship generally are presumed to be fiduciary powers. *See id.*

[28] 196 So. 299 (Fla. 1940).

[29] *See id.* at 300.

the trust property to any one or more of the settlor's descendants.[30] The individual trustee had to set forth his decision to distribute trust property to the beneficiaries in a written instrument, such as the individual trustee's will.[31] The individual trustee exercised his discretionary authority by delivering written directions to the corporate trustee to transfer the trust property to the individual and corporate trustee as trustees of a second trust.[32] The second trust conferred the same power to direct distributions to the individual trustee and his successors as the original trust, but other terms of the second trust were slightly different.[33] While the second trust was held for the benefit of the original settlor's descendants, it provided one of the settlor's children with a special testamentary power of appointment to appoint trust income to that child's wife.[34]

The *Phipps* court determined that the individual trustee's power to distribute trust property to the limited class of persons designated as trust beneficiaries was a special power of appointment, and the trustee's ability to appoint property further in trust for members of the class depended upon the extent of the power authorized under the terms of the trust agreement.[35] The court held that, as a general rule, a trustee's ability to transfer a fee simple estate in property includes the ability to create any lesser estate unless the trust instrument clearly expresses otherwise.[36] The court reasoned that the settlor had vested "unlimited confidence and discretion" in the individual trustee to distribute the trust property to the named beneficiaries, and therefore did not limit the individual trustee's ability to transfer a less than fee simple interest in the property to such beneficiaries.[37]

It should be noted that, because the individual trustee had both a lifetime and a specific testamentary power to direct distributions of trust property to the trust beneficiaries, the trustee's power in *Phipps* was more like a power of appointment than the garden-variety discretionary power to disribute trust property.[38] While the *Phipps* case is strong authority in favor of a trustee's power to appoint further in trust, the holding does not provide

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[30] *See id.*
[31] *See id.*
[32] *See id.*
[33] *See id.*
[34] *See id.*
[35] *See id.* at 301.
[36] *See id.*
[37] *See id.*
[38] *See id.* at 300.

conclusive authority that a trustee with a purely discretionary power held in a fiduciary capacity can transfer assets to a new trust.[39]

2. *Iowa: In re* Estate of Spencer

In *In re Estate of Spencer*,[40] the settlor created a testamentary trust to hold her part of certain real property also owned by her husband.[41] The trust was for the benefit of her children, who shared equally in trust income, and directed her husband, the trustee, to hold the real property until he disposed of his portion of the property during his life or at his death.[42] The terms of the trust provided the husband with a special power to dispose of the trust property by life estate to and among the settlor's children, with the remainder to such children's surviving issue.[43] In his will, the husband exercised his power by directing that a second trust hold the trust property, which also held the husband's portion of the real property.[44] The terms of the second trust directed that the trustee hold the trust property in equal shares, per stirpes, for the benefit of the four children, for the maximum period of time permitted by law.[45]

The court analyzed the husband's power as a special power of appointment that, as a general rule, could be exercised by appointing the property

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[39] Nearly all of the cases cited in the *Phipps* opinion involved a nonfiduciary exercising a power of appointment to appoint property further in trust, and only one case involved a beneficiary-trustee's special power to appoint property further in trust. *See Phipps*, 196 So. at 301 (citing Wilmington Trust Co. v. Wilmington Trust Co., 180 A. 597 (Del. Ch. 1935); Regents of Univ. Sys. v. Trust Co. of Ga., 198 S.E. 345 (Ga. 1938); Butler v. Huestis, 68 Ill. 594 (1873); Allder v. Jones, 56 A. 487 (Md. 1920); Greenough v. Osgood, 126 N.E. 461 (Mass. 1920); Guild v. Mayor, 99 A. 120 (N.J. Ch. 1916); *In re* Kennedy's Will, 18 N.E.2d 146 (N.Y. 1938); Lehman v. Spicer, 176 N.Y.S. 445 (N.Y. App. Div. 1919); Appeal of Appleton, 20 A. 521 (Pa. 1890)). In *Regents of University System*, the Supreme Court of Georgia held that, under the facts of the case, a beneficiary could appoint trust property further in trust pursuant to a special power of appointment. *See Regents of Univ. Sys.*, 198 S.E. at 347. Although the settlor gave property to his wife and a corporation as cotrustees, the wife was also the life beneficiary of the trust and was given a special power to appoint trust property at death. *See id.* Taken in context, the trust provision, apparently given in a nonfiduciary capacity, granted the wife the special testamentary power, and that the power did not run with the office of trustee. *See id.* The court, however, did not distinguish between the fiduciary or nonfiduciary nature of the power, and merely analyzed the extent of the power under the general rules governing powers of appointment. *See id.* at 349–51.

[40] 232 N.W.2d 491, 493–95 (Iowa 1975).

[41] *See id.* at 493.

[42] *See id.* at 493–94.

[43] *See id.*

[44] *See id.* at 494.

[45] *See id.*

in further trust for the benefit of permissible appointees, unless the donor of the power manifested a contrary intent.[46] The court noted that courts make the determination of a special powerholder's authority to appoint property further in trust on a case-by-case basis.[47] After reviewing the facts of the case, the court held that the appointment of the property in trust for the life of the four children was valid because it carried out the life estates that the settlor had intended to go to her children.[48] However, the court held that the appointment of the property in trust for the grandchildren was invalid because it violated the settlor's intent that the remainder interest in the property vest outright in her grandchildren after termination of the life estates.[49]

With the exception of a citation to *Phipps*, in reaching its decision the *Spencer* court relied on cases involving the authority of a beneficiary to appoint property further in trust.[50] Unlike the trust language in *Phipps,* which seemed to create a special power of appointment in an individual in his capacity as trustee, the trust language in *Spencer* appears to have granted a special power of appointment to a beneficiary-trustee in his individual capacity.[51] Nevertheless, the *Spencer* court analyzed the power under general rules regarding powers of appointment, without reference to whether the power was held in a fiduciary or nonfiduciary capacity.[52] Like *Phipps*, the *Spencer* case authorizes a trustee with a discretionary power similar to a special power of appointment to appoint trust property in further trust.[53] *Spencer*, however, is also not conclusive authority for the idea that a trustee with a purely discretionary power held in a fiduciary capacity can distribute trust property in further trust.

3. *New Jersey:* Wiedenmayer v. Johnson

In *Wiedenmayer v. Johnson*,[54] a New Jersey appellate court considered whether trustees with the absolute discretion to distribute trust property to a beneficiary could distribute property to another trust created for the beneficiary's benefit. Under the trust instrument, the trustees were authorized to distribute any or all of the trust property to the beneficiary—the settlor's son—or to use the trust property on his behalf as the trustees determined "in

46 *See id.* at 496–97.
47 *See id.* at 497.
48 *See id.* at 497–98.
49 *See id.*
50 *See id.* at 496–97 (listing cases).
51 *See id.* at 493.
52 *See id.* at 491.
53 *See id.*; Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940).
54 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969).

their absolute and uncontrolled discretion" for the beneficiary's "best interests."[55] In exercising their discretionary authority, the trustees determined that, to safeguard the beneficiary's best interests, they should condition distributions on the beneficiary setting up another trust.[56] The beneficiary agreed, and the trustees paid over all of the trust property to the new trust.[57] From the court's opinion, it appears the new trust provided protection from marital claims that the original trust did not afford.[58] The guardian *ad litem* challenged the distribution to the new trust on behalf of certain minor children and alleged that the children lost the contingent remainder interest provided to them under the original trust.[59]

In rejecting the guardian *ad litem*'s challenge to the distribution, the court reasoned that if the beneficiary received the distribution of the trust property outright—as permitted under the trust agreement—then the children would have lost their contingent remainder interest in the property that was distributed from the trust.[60] The court concluded that the trustees' distribution of trust property to another trust did not defeat the settlor's basic intention for the trust—to further the best interests of the beneficiary.[61]

Unlike the courts in *Phipps* and *Spencer*, the *Wiedenmayer* court did not analyze the trustees' distribution under the rules that relate to special powers of appointment.[62] Instead, the *Wiedenmayer* court limited its inquiry to whether the trustees' discretionary power to distribute trust property in further trust was in the beneficiary's best interest and whether the exercise of that power was an abuse of discretion.[63] The court found that the trustees properly exercised their discretion to distribute property in further trust to protect the beneficiary from future marital claims because the results of a prior divorce disturbed the beneficiary and his best interests included more than his personal financial gain, such as the effect individual wealth would have on his overall emotional well-being.[64] *Wiedenmayer* appears to authorize a trustee with a fiduciary power to distribute property to a beneficiary to distribute that property in further trust for the benefit of the beneficiary. However, while the case provides important authority in New Jersey, it is an

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55 *Id.* at 535.
56 *See id.* at 536.
57 *See id.* at 535–36.
58 *See id.* at 536.
59 *See id.*
60 *See id.*
61 *See id.*
62 *See id.* at 535–36.
63 *See id.*
64 *See id.*

intermediate appellate court case and not a binding decision of the state's highest court.

4. Two-Step Decanting Under State Law

In a private letter ruling, the Internal Revenue Service (Service) ruled that the division of trusts into separate trusts and the immediate merger of some of the newly created trusts into existing trusts did not result in adverse gift, income, or GST tax consequences where state law and the governing instrument permitted the division and merger.[65] The ruling analyzed the division and merger under the governing law of a state that had yet to adopt the Uniform Trust Code (UTC) or a decanting statute.[66]

Under the facts of the ruling, the settlor created an irrevocable trust that divided into three separate trusts, one for each child.[67] The trust entitled each child to all income of their separate trust, and an ascertainable standard limited the discretionary distributions of trust principal to the child.[68] When the separate trusts were funded, the settlor allocated sufficient GST exemption to the trusts to cause each to have a zero inclusion ratio.[69] Pursuant to state court approval, the trustee proposed to divide each separate trust into two trusts: one to hold stock, and another to hold stock redemption proceeds.[70] The trustee proposed that each new trust holding the stock redemption proceeds would then merge into another existing trust for each child containing identical terms and benefiting identical beneficiaries.[71]

The Service ruled that (1) the partition of each child's separate trust would not subject the trustee, trust assets, or beneficiaries to GST tax; (2) the merger of the trusts holding the stock redemption proceeds into the previously existing trusts would not subject any distributions from, or termination of any interest in, the previously existing trust to the GST tax; (3) the partition and merger of the trusts would not cause any trust, successor trust, or beneficiary to realize gain or loss from the sale or other disposition of the redemption proceeds; and (4) the merged trusts would take a transferred basis and holding period in the assets received in the merger.[72]

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[65] *See* I.R.S. Priv. Ltr. Rul. 200451021 (July 30, 2004).
[66] *See id.*
[67] *See id.*
[68] *See id.*
[69] *See id.*
[70] *See id.*
[71] *See id.* The existing trust into which each new trust merged had resulted from the division of the original trust four years earlier. *See id.*
[72] *See id.*

Moreover, because each trust had a zero inclusion ratio prior to division, the allocation of the redemption proceeds to trust principal did not cause the trusts to lose their GST-exempt status.[73] In analyzing the GST tax issues arising from the division of the trusts, the Service determined that the division was a "qualified severance" pursuant to Internal Revenue Code (Code) section 2642 because each single trust was divided pursuant to the governing instrument or local law, the division was on a fractional basis, and the terms of the new trusts, in the aggregate, provided for the same succession of beneficial interests to the beneficiaries as in the original trust.[74] Because the division constituted a qualified severance, each new trust retained the zero inclusion ratio of the single trust prior to division.[75] Additionally, the Service ruled that the zero inclusion ratios continued to apply to each trust resulting from the merger, and that the merger would not subject distributions from terminations of interests in the trust, or any successor trust, to the GST tax.[76]

In effect, the division and merger of the trusts in the private letter ruling was a two-step decanting of trust property from one trust to a second trust pursuant to the governing instrument and state law without any adverse tax consequences.[77] Practitioners should consider a two-step decanting under state law where neither the trust instrument nor state law expressly authorizes trust decanting.

III. REASONS FOR TRUST DECANTING

Although the original purpose of New York's trust decanting statute was to extend the GST-exempt status of grandfathered trusts, practitioners can use trust decanting to address a variety of issues.[78] For example, practitioners can use trust decanting to modernize the terms of a trust, correct drafting errors, or accommodate current administrative or management needs or the needs of the beneficiaries.[79]

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73 *See id.*
74 *See id.*
75 *See id.*
76 *See id.*
77 *See id.*
78 *See* Alan S. Halperin & Lindsay N. O'Donnell, *Modifying Irrevocable Trusts: State Law and Tax Considerations in Trust Decanting*, 42 HECKERLING INST. ON EST. PLAN. ¶¶ 1301–1301.6 (2008); Rashad Wareh, *Trust Remodeling*, TR. & EST., Aug. 2007, at 18. *See generally* Glen G. Fox, *Trust Decanting Under Common Law and Alternatives to Decanting*, reprinted in N.Y. City Bar CLE materials for "The Can's & Can'ts of Trust Decanting" (Oct. 21, 2008).
79 *See* Halperin & O'Donnell, *supra* note 78, ¶¶ 1301.4–.5.

A. Update, Modernize, or Amend Trust Provisions

Decanting provides a means to update or modernize trust provisions to reflect changes or clarifications in the law governing the trust instrument.[80] For example, if state law changes to authorize trustees to appoint trust property further in trust pursuant to a discretionary distribution power, trust decanting can be used to clarify the extent of a family trustee's ability to appoint property further in trust.

Trust decanting also can be used to improve trust administration or management, such as by combining multiple trusts to promote administrative convenience or reduce administrative costs.[81] Decanting can be used to address a trustee's ability to delegate specific functions or decisions to a cotrustee, or to appoint a successor trustee or cotrustee for a limited purpose or a specified time. For example, the new trust could provide for the appointment of a fiduciary advisor to make investment decisions, thereby protecting a less sophisticated trustee from decisions regarding those investments. Decanting also may be used to clarify the governing law of a trust and ensure uniform requirements for trust administration, enforcement, or obligations if the trustee and beneficiaries reside in several different states.[82]

If the terms of the trust contain drafting errors that are not discovered until after the trust has become irrevocable, trust decanting can be used to correct the errors, whether administrative, substantive, or distributive, to reflect more accurately the settlor's intent.[83]

B. Address Changed Circumstances

Trust decanting can be used to address the beneficiaries' changed circumstances after a trust has become irrevocable, such as creditor or marital issues, disparate accumulations of wealth, or disability.[84] For example, trust decanting can be used to transfer assets to a supplemental needs trust to enable a disabled beneficiary to qualify for public assistance. Trust decanting could also be used to modify the distributive provisions of a trust.[85] For example, a trust set to terminate when the primary beneficiary reaches a certain age could be decanted to another trust that continues for the life of the beneficiary.

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[80] *See* Wareh, *supra* note 78, at 19.

[81] *See id.*; Halperin & O'Donnell, *supra* note 78, ¶¶ 1301.2–.3.

[82] *See* Wareh, *supra* note 78, at 18–19.

[83] *See* Halperin & O'Donnell, *supra* note 78, ¶ 1301.5.

[84] *See id.* ¶ 1301.1.

[85] *See id.* ¶ 1301.3.

Much as the needs or circumstances of the beneficiaries may change, issues regarding the currently acting or successor trustees may arise.[86] Trust decanting can be used to include provisions governing the number or votes of cotrustees, distinctions in administrative powers of interested or disinterested trustees, or the order or succession of successor trustees.[87]

Trust decanting may be used to combine multiple trusts to enhance trust administration, lower administrative costs, or consolidate investment assets or other property.[88] Decanting also may be used to divide trusts or segregate certain trust assets into separate trusts for the benefit of some or all of the trust's beneficiaries.[89]

Trust decanting also may be used to change the situs or governing law of a trust.[90] For example, if the terms of an irrevocable trust specify the trust's situs or governing law, decanting may be used to modify the trust and address changes regarding the trust's governing law, situs, or principal place of administration.[91]

C. Federal or State Tax Planning

Under certain circumstances, trust decanting could be used to maximize GST planning for trust beneficiaries. For example, if a trust is set to terminate when the primary beneficiary reaches a certain age, or if the primary beneficiary has a general power of appointment, trust property could be decanted to another trust to maximize use of the settlor's and the beneficiary's available GST exemption.

Trust decanting could be used to reduce or eliminate state taxes, such as by avoiding a state's fiduciary income tax.[92] Trust decanting potentially could be used to achieve state income tax savings resulting from the interplay of the several different state income tax statutes. For example, if property of an irrevocable trust is administered in South Carolina for the benefit of South Carolina residents, trust property could be decanted to a trust with a situs in another state that does not tax income of a trust administered for the benefit of nonresidents.[93] If the terms of a trust do not permit a change of the trust's situs or principal place of administration, decanting may be

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86 *See* WILLIAM M. MCGOVERN, JR. & SHELDON F. KURTZ, WILLS, TRUSTS, AND ESTATES 349 (2d ed. West 2001).

87 *See* Halperin & O'Donnell, *supra* note 78, ¶ 1301.3.

88 *See id.* ¶ 1301.2.

89 *See id.* ¶ 1301.6.

90 *See id.* ¶ 1301.4.

91 *See id.*

92 *See id.* ¶ 1301.6.

93 *See id.*

used to modify the trust to permit changes to the trust's governing law, situs, or principal place of administration.[94]

Decanting also may allow for the division of trusts or the segregation of certain trust assets to provide tax benefits to some or all of the beneficiaries.[95] For example, if some of a trust's beneficiaries have capital gains in a given year, trust property with a capital loss could be decanted to another trust that sells the property and then terminates, passing the loss on to such beneficiaries.

IV. TAX TREATMENT OF DECANTING

Decanting raises a host of generation-skipping, gift, income, and estate tax issues.

A. Generation-Skipping Transfer Tax

The GST tax applies to every generation-skipping transfer made after October 22, 1986 (the effective date of the statute imposing the GST tax), subject to certain transition rules.[96] Although the potential to extend a trust or otherwise modify its terms is a major benefit of the ability to decant trust property to another trust, practitioners must be wary of the GST tax consequences of distributing trust property to another trust.

1. Decanting from Grandfathered Trusts

Decanting from a trust that is exempt from application of the GST tax because it was in existence and irrevocable on September 25, 1985, or because certain transition rules apply (a grandfathered trust) potentially could result in a loss of exempt status.[97] The regulations applicable to grandfathered trusts provide that the exercise of a special power of appointment will not be considered an addition to the trust if certain conditions are met, but the regulations distinguish between special powers of appointment and trust decantings, applying different rules to the latter.[98] Although the regulations provide no general rule regarding what action would cause loss of

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[94] *See id.* ¶ 1301.4.

[95] *See id.* ¶ 1301.6.

[96] *See* I.R.C. § 2601; Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(a), 100 Stat. 2085, 2731 (1986); Treas. Reg. § 26.2601-1(a).

[97] *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1433(b)(2)(A), 100 Stat. 2085, 2731 (1986); Treas. Reg. § 26.2601-1(b)(1).

[98] *See* Treas. Reg. § 26.2601-1(b)(1)(v)(B) (exercise of special power of appointment); Treas. Reg. § 26.2601-1(b)(4)(i)(A) (distributions from grandfathered trust to new or continuing trust); Treas. Reg. § 26.2601-1(b)(4)(i)(D) (modifications of trust pursuant to trustee action).

grandfathered status, the regulations do set forth certain safe harbors that apply to decantings or modifications of grandfathered trusts.[99] The regulations take the position 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.[100]

a. Exercise of a Special Power of Appointment

Under the current regulations, the exercise of a special power of appointment conferred in a grandfathered trust will not be treated as a contribution of additional property if the special power is exercised in a manner that does not violate the permissible perpetuities period (Federal Perpetuities Period).[101] The exercise of a special power does not violate the Federal Perpetuities Period if the vesting, absolute ownership, or power of alienation of an interest in property may not be suspended or postponed beyond either (1) any life in being at the date of creation of the grandfathered trust plus twenty-one years and a period of time for gestation, or (2) a ninety-year period beginning on the date of the creation of the trust.[102] For example, the exercise of a special power of appointment in favor of another trust created before or after the effective date will not subject transfers of grandfathered trust property from the second trust to the GST tax if the term of the second trust does not extend beyond the Federal Perpetuities Period.[103] However, if the term of the second trust violates the Federal Perpetuities Period, then grandfathered trust property distributed to the second trust pursuant to the special power of appointment would be treated as an addition to a trust that is no longer exempt from the GST tax.[104]

The regulations do not treat a decanting of assets from a grandfathered trust as the exercise of a special power of appointment for GST tax purposes even though the state statutes authorizing trust decanting are premised on the underlying principle that a trustee's discretionary authority to invade

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[99] *See* Treas. Reg. § 26.2601-1(b)(4).

[100] Prior to the final regulation, the Service issued private letter rulings stating that a trust would lose the exempt status if it was modified in such a way that "changes the quality, value or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust." I.R.S. Priv. Ltr. Rul. 9732034 (May 15, 1997). For a discussion of the consequences of the loss of grandfathered status, *see infra* Part IV.A.1.g.

[101] *See* Treas. Reg. § 26.2601-1(b)(1)(v)(B)(2).

[102] *See id.*

[103] *See* Treas. Reg. § 26.2601-1(b)(1)(v)(D) ex. 4.

[104] *See* Treas. Reg. § 26.2601-1(b)(1)(v)(D) ex. 5.

principal and income is equivalent to a special power of appointment.[105] The regulations treat the exercise of a special power of appointment differently from a trust decanting and provide separate rules, or safe harbors, to modifications of grandfathered trusts resulting from a decanting.[106]

b. Safe Harbor #1: The Discretionary Distribution

The regulations provide a safe harbor for certain discretionary distributions from grandfathered trusts taken pursuant to trustee action (Safe Harbor #1).[107] To qualify for Safe Harbor #1 (and preserve the grandfathered trust's exempt status) a discretionary distribution of trust property from a grandfathered trust to a new trust must meet the following three requirements:

1. On the date the grandfathered trust becomes irrevocable, either the terms of the grandfathered trust or state law (for example, state common law or a decanting statute) authorizes distributions to the new trust;[108]

2. The trustee is able to exercise the power without the consent or approval of any beneficiary or court;[109] and

3. The new trust does not postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond the Federal Perpetuities Period.[110]

Because beneficiary consent or court approval is prohibited, a decanting that satisfies Safe Harbor #1 not only should avoid adverse GST-tax consequences, but also adverse gift or income tax consequences.[111] The power to decant without beneficiary consent or court approval, however, must exist on the date the grandfathered trust became irrevocable.[112]

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105 *See, e.g.*, ALASKA STAT. § 13.36.157(c) (2008); DEL. CODE ANN. tit. 12, § 3528(c) (2007); FLA. STAT. ANN. § 736.04117(3) (West Supp. 2008); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(f) (McKinney 2002).

106 *See* Treas. Reg. § 26.2601-1(b)(1)(v)(B) (exercise of special power of appointment); Treas. Reg. § 26.2601-1(b)(4)(i)(A) (distributions from grandfathered trust to new or continuing trust); Treas. Reg. § 26.2601-1(b)(4)(i)(D) (modifications of trust pursuant to trustee action).

107 *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A).

108 *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A)(1)(ii).

109 *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A)(1).

110 *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A)(2).

111 *See* discussion at *infra* Parts IV.B.-C., V.D.

112 *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A)(1)(ii).

c. Safe Harbor #2: The Trust Modification

If a decanting does not satisfy Safe Harbor #1 because the trust document or applicable state law does not authorize a trustee to decant assets to another trust, then a distribution will not cause a grandfathered trust to lose its exempt status if the decanting is within the catch-all safe harbor governing trust modifications set forth in the regulations (Safe Harbor #2).[113] Safe Harbor #2 contains the following two requirements:

1. 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;[114] and

2. The modification does not extend the time for vesting of any beneficial interests beyond the period provided for under the terms of the grandfathered trust instrument.[115]

Safe Harbor #2 permits beneficiary consent or court approval;[116] nevertheless, beneficiary consent could raise gift and income tax issues.[117] Also, Safe Harbor #2 does not require that a decanting statute used to modify or decant property from a grandfathered trust be in existence at the time that the trust became irrevocable.[118]

d. Extending the Term of a Grandfathered Trust

As previously mentioned, an important planning objective is to extend or modify a trust grandfathered from the GST tax, when appropriate.[119] Safe Harbor #1 requires that if one decants pursuant to a state decanting statute, the statute must have been in existence on the date that the trust became irrevocable.[120] Because the first decanting statute was not enacted by New York until 1992,[121] it is unlikely that a decanting will satisfy the discretionary distribution safe harbor set forth in Safe Harbor #1 based solely on a state decanting statute.[122] Nevertheless, it may be possible to extend the

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[113] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(D).
[114] *See id.*
[115] *See id.*
[116] *See id.*
[117] *See infra* Parts IV.B.-C., V.D.
[118] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(D).
[119] *See supra* Part II.
[120] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A).
[121] *See supra* Part II.
[122] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A); *see also* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b) (McKinney 2002).

term of a grandfathered trust pursuant to Safe Harbor #1 if the terms of the grandfathered trust instrument or the common law of the governing jurisdiction authorize a distribution of trust property to another trust. For example, if the terms of a grandfathered trust authorize the trustee to make distributions of property in further trust for some or all of the beneficiaries, it is possible to extend the term of the trust without losing its exempt status so long as the duration of the new trust does not violate the Federal Perpetuities Period set forth in the regulation.[123] Although it may be desirable to change the situs of a grandfathered trust to a state with case law supporting a common law right to decant, one could argue also that a state's decanting statute is declarative of existing common law.

The term of a grandfathered trust cannot be extended under Safe Harbor #2 without causing a loss of grandfathered status. To satisfy Safe Harbor #2, a trust modification cannot extend the term of a grandfathered trust beyond that originally provided for in the trust instrument.[124] For example, if the trust situs is changed from a state that applies the traditional common law rule against perpetuities to a state that has repealed the rule against perpetuities, the trust would lose grandfathered status if in the first state the trust would terminate within twenty-one years and a life in being, but, because of the change in situs, the trust term would continue indefinitely.[125] On the other hand, the trust would not lose grandfathered status if the change in situs did not result in an extension of the trust term beyond that provided for in the grandfathered trust instrument. In this latter case, the change in situs would not result in an impermissible shift of beneficial interests to lower generations or an extension of the time for vesting of any beneficial interest beyond that provided for in the original trust.[126]

e. Changes to Administrative Provisions

Safe Harbor #1 could be used to change administrative provisions of a trust through a trust decanting if the trust instrument or state law authorizes it at the time the trust becomes irrevocable.[127] In addition, the regulations

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[123] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(E) ex. 1 (providing example of when a discretionary trust for child and child's issue that terminates upon death of the child would not lose grandfathered status if, pursuant to the terms of the governing instrument, property is distributed to another trust for the benefit of the child's issue that terminates 21 years after the death of the survivor of the child's issue living on the date the original trust was established).

[124] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(D).

[125] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(E) ex. 4.

[126] *See id.*

[127] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1).

clarify that administrative changes will not taint the tax-exempt status of a grandfathered trust under Safe Harbor #2.[128] The Service will not consider a modification that is administrative in nature and only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) as a shift of a beneficial interest in the trust.[129]

f. Shifts of Beneficial Interests Among Generations

Under Safe Harbor #1, beneficial interests may be moved up, down, or across generations as long as the decanting does not violate the Federal Perpetuities Period.[130] If authorized by the trust instrument or state law at the time the trust becomes irrevocable, a decanting can be used to accelerate future beneficial interests of lower generations to present interests in trust property or to create remainder interests in trusts for generations not provided for under the original trust instrument.[131] Because beneficiary consent or court approval is prohibited, a decanting pursuant to Safe Harbor #1 that shifts beneficial interests among generations should avoid not only adverse GST-tax consequences, but also adverse gift or income tax consequences to the trust beneficiaries.

Safe Harbor #2 permits a modification that does not shift a beneficial interest to a generation that is lower than the one that held it before the change, so beneficial interests in a grandfathered trust could be moved up or across generations of beneficiaries, but not down.[132] The regulations provide an example of a trust modification that would not result in an impermissible shift of beneficial interests to a lower generation under Safe Harbor #2—where "the modification does not increase the amount of a GST transfer under the original trust or create the possibility that new GST transfers not contemplated in the original trust may be made."[133] For example, if a trust authorizes discretionary distributions to *A* and *A*'s issue during the life of *A*, a distribution of trust property to a new trust solely for *A*'s benefit for life would not shift a beneficial interest in the trust to a lower generation.[134] If

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[128] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(E) ex. 6.

[129] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(E) ex. 10.

[130] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A)(2).

[131] *See id.*

[132] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(E) ex. 7 (providing that no impermissible shift in beneficial interests results where trust modification increases share of trust income for current beneficiary and decreases respective shares of other current beneficiaries where all current beneficiaries are members of the same generation for GST-tax purposes).

[133] *Id.* Gift and income tax issues should nevertheless be considered. *See* discussion at *infra* Parts IV.B.-C., V.D.

[134] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(E) ex. 2.

the trust were to continue for the benefit of *A*'s natural grandchildren at the death of *A*, a trust modification to include legally adopted grandchildren as beneficiaries at *A*'s death would result in a permissible shift of future beneficial interests within generations and not a prohibited shift to lower generations.[135] If the grandfathered trust terminated upon the life of *A*, however, property distributed to the new trust would lose grandfathered status if remainder interests in the trust property were extended beyond *A*'s life.[136]

g. *Consequences of Loss of Grandfathered Status*

The Service has not resolved the treatment of a trust that loses its grandfathered status for failing to satisfy the regulatory safe harbors. In private letter rulings, the Service initially indicated that upon loss of grandfathered status, the Service would deem the current beneficiaries to create a new trust in a transaction subject to the gift tax.[137] The Service later reconsidered its position and held that the settlor of a grandfathered trust is treated as the transferor for GST-tax purposes after the trust loses its grandfathered status.[138] While the treatment of loss of exempt status is still uncertain, most commentators feel that loss of grandfathered status does not subject all future distributions from the trust to GST tax.[139] Distributions from the second trust to beneficiaries who could not have received distributions free of GST tax from the original trust likely would be subject to GST tax,[140] but whether and to what extent the settlor's GST tax exemption would be applied to a trust losing grandfathered status remains unclear. Nevertheless, in determining whether to jeopardize a trust's grandfathered status, the trustee should consider the overall impact of exposing trust property to the estate tax upon termination of the trust term versus the application of the GST tax to property held in further trust for future generations.

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[135] *See*, *e.g.*, I.R.S. Priv. Ltr. Rul. 200917004 (Apr. 24, 2009) (ruling that amendment to include legally adopted issue as trust beneficiaries did not result in impermissible shift of future beneficial interests in trust property where amendment merely expanded members of class of beneficiaries otherwise entitled to receive trust property).

[136] *See id.*

[137] *See* I.R.S. Priv. Ltr. Rul. 9421048 (May 27, 1994); I.R.S. Priv. Ltr. Rul. 9448024 (Dec. 2, 1994).

[138] *See* I.R.S. Priv. Ltr. Rul. 9522032 (June 2, 1995).

[139] *See*, *e.g.*, CAROL A. HARRINGTON, LLOYD LEVA PLAINE & HOWARD M. ZARITSKY, GENERATION-SKIPPING TRANSFER TAX: ANALYSIS WITH FORMS ¶ 7.06[3] (2d ed. 2001).

[140] *See* Halperin & O'Donnell, *supra* note 78, ¶ 1304.5.

2. *Decanting from Zero Inclusion Ratio Trusts*

Other than the qualified severance rules, there is no statutory or regulatory guidance on the GST-tax consequences of decanting property from post-effective-date trusts that are not grandfathered from application of the GST tax. The qualified severance statute[141] and corresponding regulations provide guidance on divisions of trusts to achieve separate inclusion ratios of zero and one, but they do not address distributions or modifications of trusts that extend the term or otherwise modify the provisions of a non-grandfathered trust, including zero inclusion ratio (ZIR) trusts exempt from GST tax from allocation of the settlor's GST tax exemption. As a practical matter, if property is decanted from a ZIR trust to a new trust pursuant to either a qualified or nonqualified severance, the ZIR trust and the new trust should have an inclusion ratio of zero.[142]

a. *Application of Safe Harbors to ZIR Trusts*

The regulatory safe harbors relating to grandfathered trusts do not apply to ZIR trusts, but private letter rulings have extended application of the safe harbors to ZIR trusts by analogy. In a private letter ruling, the Service considered the effect that a trust decanting would have on a ZIR trust.[143] The ruling involved a ZIR trust for the benefit of the settlor's child and child's issue that was set to terminate upon the later of the death of the settlor or the settlor's child.[144] Apparently, the trustee wanted two similar trusts, and changed the trust's situs to another state that had enacted a trust decanting statute that became effective before the formation of the trust.[145] Pursuant to the decanting statute, the trustee exercised the power to appoint trust assets to a new trust with terms virtually identical to the original trust.[146] In the ruling, the Service recognized that no guidance had been issued with respect

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[141] *See* I.R.C. § 2642(a)(3) (2006) The qualified severance statute was temporarily added by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 101-508 section 562(a) and currently is set to sunset after December 31, 2010.

[142] Each separate trust resulting from a qualified severance of a ZIR trust would have an inclusion ratio of zero. *See* Treas. Reg. § 26.2642-6(d)(6). If a ZIR trust is divided into one or more multiple trusts pursuant to a nonqualified severance, the resulting trusts would have a zero inclusion ratio and would be recognized as separate trusts for GST-tax purposes if the division is recognized under state law. *See* Treas. Reg. § 26.2642-6(h).

[143] *See* I.R.S. Priv. Ltr. Rul. 200743028 (May 29, 2007).

[144] *See id.*

[145] *See id.* The ruling did not explain why the taxpayer wanted to decant trust property to a separate trust. *See id.*

[146] *See id.*

to how such changes may affect the status of a ZIR trust.[147] However, in the ruling the Service conceded that, "[a]t a minimum, a change that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of [a ZIR] trust."[148] The Service analyzed the effect of the trust decanting under the grandfathered trust safe harbor rules and concluded that because the decanting did not shift beneficial interests to lower generations or extend the time for vesting of any beneficial interest beyond the period provided for in the original trust, both the new trust and the original trust would have an inclusion ratio of zero.[149]

The Service recently reconsidered the lack of guidance with respect to how modifications to a ZIR trust might affect the trust's zero-inclusion-ratio status, and again applied the grandfathered trust safe harbor rules to such modifications.[150] In this instance, the Service ruled that modifications to a ZIR trust that were only administrative in nature would not cause the trust to have an inclusion ratio greater than zero because, at a minimum, mere administrative changes would satisfy the grandfather trust safe harbors.[151]

The position the Service has taken in private letter rulings provides some comfort that a trust decanting that otherwise satisfies the safe harbors will not affect a ZIR trust's inclusion ratio. On the face of the regulations, the safe harbors apply only to grandfathered trusts, namely trusts that were (1) irrevocable on September 25, 1985; (2) revocable on the effective date, and either no amendment or addition to the trust is made thereafter that results in the creation of, or an increase in the amount of, a GST; or (3) included in the estate of an individual under a mental disability to change the disposition of the individual's property continuously from the effective date until the date of death.[152] In the absence of statutory or regulatory guidance, however, changes to or distributions from trusts pursuant to a decanting that does not meet the grandfathered trust safe harbors should not affect the zero inclusion ratio of ZIR trusts. The result should be the same whether the decanting shifts beneficial interests among generations or extends the duration of a ZIR trust beyond the period originally provided for in the trust instrument, such as by decanting the trust property to a perpetual or dynasty trust in a state that has repealed the traditional rule against perpetuities.[153]

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[147] *See id.*

[148] *Id.*

[149] *See id.*

[150] *See* I.R.S. Priv. Ltr. Rul. 200919008 (May 8, 2009).

[151] *See id.* (citing Treas. Reg. § 26.2601-1(b)(4)(i)(E) ex. 10).

[152] *See* Treas. Reg. § 26.2601-1(b)(4).

[153] Care should be taken to ensure that the extension does not violate the "Delaware Tax Trap." *See* discussion at *infra* Part IV.B.4.

b. Extending the Term of ZIR Trusts

Prior to the amendment of the final regulations on May 20, 1997, the regulations provided that the exercise of a special power of appointment in a nongrandfathered trust would be treated as a transfer subject to federal gift and estate tax if the exercise extended the term of an original trust beyond the Federal Perpetuities Period, and the powerholder would be the deemed transferor of the trust after the exercise of the power.[154] The Service intended the regulation to subject a ZIR trust that was extended pursuant to a special power of appointment to GST tax where none would have applied otherwise.[155] A subsequent amendment to the regulation 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 move the identity of the transferor to the generation of the powerholder tax-free.[156] Therefore, 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.[157]

Consequently, by analogy, it also should be possible to extend the term of a ZIR trust through a trust decanting, because nearly every state decanting statute specifically treats the trustee's power to decant as the exercise of a special power of appointment.[158] Even assuming that a trustee's power to decant is treated differently from a special power of appointment for GST-tax purposes, the regulations governing "rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust" causes the trust to lose its GST-tax-exempt status apply only to trusts grandfathered from application of the GST tax.[159] In the ab-

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[154] *See* Treas. Reg. § 26.2652-1(a)(4) (2006) (subsequently amendment by T.D. 8720, 1997-1 C.B. 187).

[155] *See* T.D. 8720, 1997-1 C.B. 187.

[156] *See id.*

[157] *See* HARRINGTON ET AL., *supra* note 139, ¶ 2.02[1]. Care must be taken to ensure that the extension does not violate Code sections 2041(a)(3) and 2514(d), commonly known as the "Delaware Tax Trap." 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. *See* discussion at *infra* Part IV.B.4.

[158] *See*, *e.g.*, ALASKA STAT. § 13.36.157(c) (2008); DEL. CODE ANN. tit. 12, § 3528(c) (2007); FLA. STAT. ANN. § 736.04117(3) (West Supp. 2008); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(f) (McKinney 2002); N.C. GEN. STAT. § 36C-8-816.1(b) (2009).

[159] *See supra* note 152 and accompanying text. These primarily are trusts that were (1) irrevocable on September 25, 1985; (2) revocable on the effective date, and either no amendment or addition to the trust is made thereafter that results in the creation of, or an increase in the amount of, a GST; or (3) included in the estate of an individual under a

sence of statutory or regulatory authority extending application of the grandfathered trust safe harbors to ZIR trusts, it may be possible to extend a ZIR trust in a manner that would violate the regulatory safe harbors, such as by decanting the trust property to a perpetual or dynasty trust in a state that has repealed the traditional rule against perpetuities.[160]

B. Estate & Gift Tax Issues

There generally should be no adverse estate tax consequences to a decanting unless:

(1) the second trust provides a beneficiary with a general power of appointment that would cause the trust property to be included in the beneficiary's estate under section 2041;[161]

(2) the decanting results in an incomplete gift that becomes complete on a beneficiary's death;[162] or

(3) the settlor's involvement in the decanting is proof of the settlor's implied right to control trust property under sections 2036 or 2038.[163]

Decanting can raise a number of gift tax issues depending on the facts and circumstances surrounding the transfer. A gift tax issue may arise where, as part of a decanting, a trust beneficiary causes or permits the beneficiary's interest in the trust to pass to another beneficiary.[164] But a trustee's exercise of a decanting power should not raise gift tax issues unless either: (1) the trustee exercising the power to decant is a beneficiary;[165] or (2) a

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mental disability to change the disposition of the individual's property continuously from the effective date until the date of death.

[160] Care should be taken to ensure that the extension does not violate the Delaware Tax Trap. *See* discussion at *infra* Part IV.B.4. Care also should be taken to ensure that the extension does not violate the terms of the original trust. For an in-depth discussion of extending the term of ZIR trusts, *see* William R. Culp, Jr. & Briani L. Bennett, *Use of Trust Decanting To Extend the Term of Irrevocable Trusts*, EST. PLAN., June 2010, Vol. 37, No. 6, at 7.

[161] *See* I.R.C. § 2041(a)(2).

[162] *See* I.R.C. § 2041(a)(3)(B).

[163] *See* I.R.C. § 2041(a)(2). *But cf.* I.R.S. Priv. Ltr. Rul. 200919008 (May 8, 2009) (ruling that settlor's exercise of power to amend trust agreement with consent of all trust beneficiaries did not cause inclusion of trust property in settlor's gross estate because settlor retained no interest in, or power over, income or corpus of property transferred to trust where power to amend was granted pursuant to state statute and not trust instrument).

[164] *See* Treas. Reg. § 25.2511-1(g)(1), (2).

[165] *Cf. id.* (providing 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); I.R.S. Priv. Ltr. Rul. 8824025 (March 17, 1988) (ruling

beneficiary's consent is required to exercise the trustee's power to decant.[166] In either event, however, a gift should not occur unless all or a portion of a beneficiary's interest in the original trust is shifted to someone other than the beneficiary.[167] If the interest that shifts is subject to an ascertainable standard, then the shift may not be a taxable transfer, either because the interest is not "property" in which the beneficiary had an enforceable right, or because the shift, in effect, is a release of a special power of appointment.[168] If the transfer of a beneficial interest in property by a trust decanting is subject to either the discretion of an independent trustee or an ascertainable standard, then the interest arguably would be so uncertain that it would not be subject to the gift tax.[169] This especially would appear true where the transfer is of a beneficial interest in a sprinkle trust that authorized discretionary distributions to or among more than one beneficiary.[170]

1. *Trustee-Beneficiary Decanting*

If a trustee is a beneficiary, a decanting by the trustee-beneficiary raises potential gift tax issues. Generally, a trustee who is also a beneficiary of the trust should not participate in a decanting.[171] The regulations provide that no

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that consent of cotrustee that is sole income beneficiary of trust to distribution of principal to remainder beneficiaries would result in a taxable gift).

[166] *See*, *e.g.*, Cerf v. Comm'r, 141 F.2d 564 (3d Cir. 1944) (holding that where a beneficiary's right to receive trust income could not be impaired without the beneficiary's consent, the beneficiary's consent to amendment of trust that eliminates the beneficiary's control over the right to receive income constitutes a taxable gift); *see also* I.R.S. Priv. Ltr. Rul. 200917004 (Apr. 24, 2009) (ruling that court approved amendment to include legally adopted issue as trust beneficiaries results in taxable gift by natural issue of future beneficial interests in trust property relinquished by the trust modification); I.R.S. Priv. Ltr. Rul. 8535020 (May 30, 1985) (ruling that discretionary beneficiary's exercise of special power of appointment would result in taxable gift).

[167] *See* Treas. Reg. §§ 25.2511-1(g)(1)–(2).

[168] *See* Henry J. Lischer, Jr., 845-2d T.M., *Gifts*, at A-55 (2005).

[169] *See generally* Christopher P. Cline, 825-3d T.M., *Powers of Appointment—Estate, Gift, and Income Tax Considerations*, at A-45 (2007); *see also* Treas. Reg. § 25.2511-1(g)(2) (providing that distribution by trustee with beneficial interest in trust is not a taxable transfer if limited by ascertainable standard); *cf.* I.R.S. Priv. Ltr. Rul. 8905035 (Nov. 4, 1988) (ruling that sole income beneficiary's release of right to receive discretionary distributions of income results in taxable gift).

[170] Private letter rulings suggest that transfers of discretionary interests in trust property result in taxable gifts. *See*, *e.g.*, I.R.S. Priv. Ltr. Rul. 8535020 (May 30, 1985) (ruling that discretionary beneficiary's exercise of special power of appointment would result in taxable gift).

[171] North Carolina's decanting statute does not permit a trustee that is a beneficiary to participate in a decanting. *See* N.C. GEN. STAT. § 36C-8-816.1(d) (2009).

taxable gift would result from a trustee's distribution of trust property to another beneficiary where the trustee has no beneficial interest in the trust.[172] A taxable gift, however, may arise where the trustee has a beneficial interest in the trust, unless distributions are limited by an ascertainable standard.[173]

2. *Beneficiary Consent to Decanting*

Practitioners should take care to ensure that a taxable gift does not result from a decanting of trust property if the decanting requires a beneficiary's consent or if the beneficiary actually consents to the decanting.[174] It is also possible that the Service would argue that a beneficiary's failure to object to a decanting is tantamount to a gratuitous transfer.[175] The success of this latter argument, however, would be questionable where the trustee initiates the action and the beneficiary's consent is not required to exercise the power to decant.[176] If a beneficiary is entitled to receive trust property on termination of a trust and the beneficiary's consent is required to approve a transfer of property from one trust to another, then a decanting that shifts property to another trust could result in a taxable gift.[177] The Service also

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[172] *See* Treas. Reg. § 25.2511-1(g)(1).

[173] *See* Treas. Reg. § 25.2511-1(g)(2).

[174] *See*, *e.g.*, Sexton v. United States, 300 F.2d 490 (7th Cir. 1962) (holding that where two-thirds vote of beneficiaries was required to extend trust term, the beneficiary that joined in unanimous consent to extend the trust term resulted in a taxable gift of the beneficiary's right to receive trust corpus 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 trustee's acquiescence to recapitalization that diminished value of property subject to beneficiary's general power of appointment).

[175] *See S*nyder v. Comm'r., 93 T.C. 529, 547–48 (1989) (holding that taxpayer made continuing gifts because of annual failure to exercise right to convert seven percent noncumulative preferred stock to another class of preferred stock that paid annual seven percent dividend).

[176] *See, e.g.*, Estate of DiMarco v. Comm'r, 87 T.C. 653, 661–64 (1986) (holding no taxable gift by beneficiary of employee benefit plan where beneficiary had no ability to select or change successor beneficiaries or to affect or determine the amount or timing of benefits payable to them); Treas. Reg. § 26.2601-1(b)(4)(i)(A)(1) (providing that to retain grandfathered status, trust instrument or state law must authorize distribution of property to another trust without the consent of the beneficiary).

[177] *See* I.R.S. Priv. Ltr. Rul. 9451049 (Sept. 22, 1994) (ruling that where beneficiary's right to income and principal was limited by an ascertainable standard, beneficiary's exercise of special power of appointment to appoint assets to her sibling's trust constituted a transfer of her beneficial interests in the trust under Code section 2511(a) and Treasury Regulation section 25.2514-1(b)(2)). *But see* Cline, *supra* note 169, at A-45 (commenting that exercise

could take the position that a beneficiary's right to receive trust property when the beneficiary reaches a certain age or upon the happening of a certain event should be treated as a general power of appointment. This position would result in a taxable gift if trust property were decanted to another trust because the decanting is equivalent to the beneficiary's release of a general power of appointment.[178] However, if the beneficiary's consent is not required to effect the decanting and the beneficiary does not possess a presently enforceable right to receive trust property, no gift should result from a trustee's exercise of a discretionary power to decant property to another trust.[179]

3. Shift of Beneficial Interests

It is possible for a trust decanting or modification to cause a shift of beneficial interests that is a taxable transfer for gift tax purposes. For example, a trust amendment that would not cause the loss of a grand-fathered trust's GST-tax-exempt status nevertheless may result in a taxable gift by the trust beneficiaries. In Private Letter Ruling 200917004,[180] the Service considered the GST-tax consequences of an amendment to a grandfathered trust. The settlor established a revocable trust that became irrevocable on his death prior to September 26, 1985.[181] At the settlor's death, an irrevocable trust was established for one of the settlor's children and her issue.[182] The definition of *issue* or *descendants* did not include legally adopted issue.[183]

At the death of the settlor's child, trust income became currently distributable to the child's two children, Child *A* and Child *B*.[184] At the death of Child *A* and Child *B*, the trust income would be distributable to their respec-

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of special power of appointment by beneficiary with right to income limited to discretion of independent trustee or to ascertainable standard would appear not to be subject to gift tax).

178 *See* I.R.S. Tech. Adv. Mem. 94-19-007 (Feb. 3, 1994). In this memorandum, the taxpayer was the sole beneficiary of a trust with a current right to trust income and a right to trust principal at age thirty. The taxpayer exercised a special power of appointment granted in the trust to appoint her interest in one trust to another trust for the benefit of certain family members. The IRS ruled that the exercise was a taxable gift under Code section 2511, or, in the alternative, was a release of a general power under Code section 2514. Query if the answer would have been different if the taxpayer had been one of the several discretionary beneficiaries of the trust.

179 *See* Treas. Reg. §§ 25.2511-1(c)(1), 25.2514-1(b)(1).

180 *See* I.R.S. Priv. Ltr. Rul. 200917004 (Dec. 16, 2008).

181 *See id.*

182 *See id.*

183 *See id.*

184 *See id.*

tive issue, per stirpes.[185] The trust would continue until fifteen years after the death of the last survivor of the trust beneficiaries in being at the settlor's death, who were Child *A*, Child *B*, and two natural children of Child *A*—*GC1* and *GC2*.[186]

In addition to the two natural children, *GC1* and *GC2*, Child *A* had a legally adopted child—*GC3*.[187] *GC1* had two legally adopted children—*GGC1* and *GGC2*.[188] *GC2* had two natural children—*GGC3* and *GGC4*.[189] Because the trust did not include *GC3*, *GGC1*, and *GGC2* in the definition of *issue* or *descendants*, those individuals were not entitled to receive distributions of trust property.[190] The trustee filed a petition in state court to revise the definition of *issue* and *descendants* to include legally adopted children, which the court granted.

In analyzing the GST-tax consequences of the revision to the trust, the Service determined that the modification satisfied Safe Harbor #2 because the amendment did not result in a shift of beneficial interests to a lower generation or an extension of the original term of the trust.[191] Although the trust included additional beneficiaries of generations lower than Child *A* as a result of the modification, the inclusion of legally adopted children did not cause an impermissible shift of beneficial interests because it did not increase the amount of a GST transfer under the original trust or create the possibility that new GST transfers not contemplated in the original trust may be made.[192] At Child *A*'s death, a portion of *GC1*'s and *GC2*'s future interests in property were shifted to *GC3*, and a portion of *GGC3*'s and *GGC4*'s future interests in trust property at the ultimate termination of the trust were shifted to *GGC1* and *GGC2*.[193] Therefore, the amendment to include legally adopted children merely affected a shift of beneficial interests within generations otherwise entitled to receive trust property under the terms of the original trust.[194]

Although the ruling does not state whether the trust beneficiaries were required to consent to the amendment to the trust, the Service ruled that each of Child *A*'s natural issue, *GC1*, *GC2*, *GGC3*, and *GGC4*, made a gift

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185 *See id.*
186 *See id.*
187 *See id.*
188 *See id.*
189 *See id.*
190 *See id.*
191 *See id.*; *see also* Treas. Reg. § 26.2601-1(b)(4)(i)(D).
192 *See* I.R.S. Priv. Ltr. Rul. 200917004 (Dec. 16, 2008).
193 *See id.*
194 *See id.*

of their future interest in the trust income and principal that was relinquished to *GC3*, *GGC1*, and *GGC2* as a result of the amendment.[195] As discussed above, however, the Service did not view such taxable gifts as transfers that would be subject to GST tax.[196]

However, if a beneficiary has the same interest in the second trust that the beneficiary had in the original trust, then a decanting from the original trust to the second trust should not result in a gift by the beneficiary regardless of whether the beneficiary consents. If a real concern exists that a decanting may result in a taxable gift by a beneficiary of the original trust, then the beneficiary of the original trust could be given a testamentary special power of appointment over the property in the second trust. The special power of appointment should cause any potential gift to be an incomplete transfer for tax purposes.[197] A subsequent distribution of trust property from the second trust to a beneficiary other than the one holding the testamentary special power of appointment could complete the gift, if any, for gift tax purposes.[198] Under Code sections 2036 and 2038, upon the holder's death, the estate of the holder of the testamentary special power of appointment would include the amount of any incomplete gift.[199] Giving the beneficiary the power to add to the class of beneficiaries of the second trust could potentially avoid or defer a taxable gift.[200]

4. Delaware Tax Trap

Another gift tax issue that may be a concern when decanting pursuant to the terms of a trust instrument or state law is Code section 2514(d), known as the "Delaware Tax Trap."[201] This section treats the exercise of special power of appointment as a transfer for gift tax purposes if (1) the donee exercises a granted power to create another power of appointment; and (2) under applicable local law, the new power of appointment can be validly exercised "to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."[202] If the power is exer-

195 *See id.*
196 *See supra* Part IV.A.1.
197 *See* Treas. Reg. § 25.2511-2(c).
198 *See id.*
199 *See* I.R.C. §§ 2036, 2038.
200 *See* Treas. Reg. § 25.2511-2(c).
201 *See* I.R.C. § 2514(d).
202 *Id.*

cised during lifetime, that exercise is treated as a gift.[203] The exercise of the power at death can result in an estate tax.[204] Whether or not the second power is exercised is irrelevant to the imposition of gift tax on the exercise of the first power; all that is required for a gift tax is that the validity of the exercise of the second power be measured without regard to the date of creation of the first power.[205]

This may not be a concern when decanting pursuant to a statute drafted to avoid a violation of Section 2514(d).[206] For example, North Carolina's decanting statute makes clear that the permissible period for the suspension of the power of alienation of property held in trust pursuant to the exercise of a power of appointment must be determined by reference to the date of creation of the first power.[207] Also, the Delaware Tax Trap should not apply to a decanting by an independent trustee that does not have a beneficial interest in the trust in which the power is granted.[208] Although the decanting may qualify as a transfer under the Delaware Tax Trap provisions, it seems logical that no gift should result if the decanting is effected in furtherance of a trustee's fiduciary duty to the trust or its beneficiaries.[209] Nevertheless, it would be advisable to include a clause in the second trust or the decanting resolution providing that the vesting or suspension of absolute ownership or power of alienation cannot extend through the exercise of a special power of appointment beyond a period applicable to the creation of the first trust.[210]

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[203] *See id.*

[204] *See id.*

[205] *See id.*

[206] *See, e.g.*, ALASKA STAT. § 13.36.157(a)(3) (2008); FLA. STAT. § 726.04117(3) (West Supp. 2008); N.Y. Est. Powers & Trusts Law § 10-6.6(f) (McKinney 2002); N.C. GEN. STAT. §§ 36C-8-816.1(c)(8), (d), 41-23(c) (2009); S.D. Codified Law §§ 43-5-5, 55-2-20 (Supp. 2008); TENN. CODE ANN. § 35-15-816(27)(C) (2007).

[207] *See* N.C. GEN. STAT. §§ 36C-8-816.1(c)(8), (e), 41-23(c) (2009). For a discussion of a similar statute, see *Estate of Murphy v. Commissioners*, 71 T.C. 671 (1979) (holding that 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).

[208] *See* Culp & Bennett, *supra* note 160, at 9.

[209] The gift tax is imposed on "the transfer of property by gift." I.R.C. § 2501(a)(1). Although donative intent is not an essential element for the gift tax to apply to a gratuitous transfer, the regulations clarify that the gift tax is applicable only to a transfer of a beneficial interest in property. *See* Treas. Reg. § 25.2511-1(g)(1). As such, a gift should not result from a trustee's distribution of property to beneficiaries other than himself if the trustee has no beneficial interest in the distributed property.

[210] *See* Halperin & O'Donnell, *supra* note 78, ¶ 1308.2.

C. Income Tax Issues

Generally, a decanting of trust property from one domestic trust to another will be a nonrecognition event.[211] If all of the assets of a complex trust are decanted into a second trust, the transfer arguably should be disregarded for income tax purposes because the decanting constitutes a trust modification and the second trust is treated as a continuation of the original trust.[212] Also, a trust decanting should not raise income tax issues if both the original trust and the second trust are grantor trusts taxed to the same settlor under Code sections 671 through 679. A trust decanting generally should produce taxable income only if (1) the decanting results in a sale or exchange of property under Code section 1001, and (2) the sale or exchange results in receipt of property that is materially different from the property given up.[213]

1. Material Difference Standard: Change in Legal Entitlements and Interests of Trust Beneficiaries

Under *Cottage Savings Ass'n v. Commissioner*,[214] a transfer of assets from one trust to another may result in a taxable exchange to the beneficiaries of the first trust if (1) the beneficiaries possess interests in the second trust that are materially different, and (2) the transfer requires their approval. *Cottage Savings* concerns the issue of when a sale or exchange has taken place that results in the realization of gain or loss under Code section 1001.[215] In *Cottage Savings*, "a financial institution . . . exchange[d] its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans."[216] The agency that regulated the financial institution considered the two groups of mortgages

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[211] *See id.* ¶ 1306.2. A transfer to or from a foreign trust can result in substantial income tax consequences. A discussion of these consequences is beyond the scope of this Article, but see Howard D. Rosen, 854-3d T.M., *U.S. Taxation of Foreign Estates, Trusts & Beneficiaries* (2008) for a comprehensive discussion of such a transfer.

[212] *See*, *e.g.*, I.R.S. Priv. Ltr. Rul. 200736002 (Sept. 7, 2007) (ruling that division of trust into multiple separate trusts on a pro rata basis constituted a trust modification for federal income tax purposes so that successor trusts were treated as continuation of original trust and no gain or loss was recognized on the pro rata division and distribution).

[213] *See*, *e.g.*, Treas. Reg. § 1.1001-1(h) (providing that severance of a trust would not constitute an exchange of property for other property differing materially either in kind or extent if applicable state law or governing instrument authorizes severance of the trust and non-pro-rata funding of the trusts resulting from the severance).

[214] 499 U.S. 554 (1991).

[215] *See id.*

[216] *Id.* at 556.

"substantially identical."[217] The U. S. Supreme Court concluded that Treasury Regulation section 1.1001-1 reasonably interprets Code section 1001(a) and held that an exchange of property gives rise to a realization event under Code section 1001(a) if the properties exchanged are "materially different."[218] In defining what constitutes a material difference for purposes of Code section 1001(a), the Court stated that properties are different in a material sense as long as their respective possessors enjoy legal entitlements that are different in kind or extent.[219] The Court held that mortgage loans made to different obligors and secured by different homes did embody distinct legal entitlements, and that the taxpayer realized losses when it exchanged interests in loans.[220]

In Private Letter Ruling 200736002, the Service ruled that if a trust is divided into multiple "successor trusts on a pro-rata basis, the division [would] not result in the realization or recognition of gain or loss."[221] Moreover, even though the division would change the terms governing who would serve as trustees, the legal entitlements and interests of the beneficiaries of each of the separate successor trusts would not differ materially in kind or extent from their interests in the original trust.[222] Accordingly, no gain or loss would be recognized by the trust, by any of the successor trusts, or by any beneficiary of those trusts on the partition of trust for purposes of sections 61(a)(3) or 1001(a).[223]

In general, a trust decanting should not be treated as a sale or exchange if the governing instrument or state law authorizes the decanting.[224] Under the regulations, an exchange of property differing materially in kind or extent should not result from a trust decanting where the governing instrument or an applicable state statute authorizes the decanting by the trustee and a non-pro-rata funding of the trusts resulting from the decanting.[225] However,

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[217] *See id.* at 557.
[218] *See id.* at 560–61.
[219] *See id.* at 564–65.
[220] *See id.* at 566.
[221] I.R.S. Priv. Ltr. Rul. 200736002 (Sept. 7, 2007).
[222] *See id.*
[223] *See id.*
[224] *See*, *e.g.*, I.R.S. Priv. Ltr. Rul. 200743022 (Oct. 26, 2007) (ruling that no sale or exchange would result from merger of trusts pursuant to governing instrument and state law).
[225] *See* Treas. Reg. § 1.1001-1(h) (as amended in 2007) (providing rules for when severance of trust results in exchange of property differing materially in kind or extent); *see also* I.R.S. Priv. Ltr. Rul. 200010037 (Dec. 13, 1999) (ruling that no sale or exchange occurs where partition of trusts did not result from exchange of interests in trusts by beneficiaries, but rather from authority to divide trust granted to trustee by donor at time of trust's creation).

if neither the terms of the trust nor state law authorizes the decanting or a non-pro-rata division of trust property, a taxable exchange could result from a beneficiary's acquiescence or consent to a decanting of trust property to another trust on a non-pro-rata basis.[226]

2. Transfers Carrying Out Distributable Net Income

The distribution of trust assets from an original trust to a second trust possibly may carry out a share of the trust's distributable net income (DNI) under section 662(a).[227] In that event, the second trust would receive taxable income and the original trust would have a corresponding deduction under section 661(a).[228] This carryout of DNI should not create net income in the aggregate, but it may result in an unexpected shift of income and deductions. The ability to carry out DNI through a trust decanting also creates the ability to shift taxable income from a complex trust that has net taxable income to a complex trust that has excess deductions. The Service also has ruled that a transfer of all of the assets from one trust to another is ignored for income tax purposes and the transfer does not result in a distribution of DNI from the first trust to the second trust.[229]

3. Transfers of Property with Debt in Excess of Basis

The recognition of gain (recapture gain) could arise where a trustee transfers to a second trust either (1) property encumbered with debt in excess of basis,[230] or (2) a partnership or LLC interest with a negative capital account.[231] In *Crane v. Commissioner*, the U. S. Supreme Court held that a transfer of property with liabilities in excess of basis resulted in gain under section 1001.[232] In addition, section 752(d) provides that the transfer of a partnership interest with liabilities in excess of basis will result in a gain to

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[226] *See*, *e.g.*, Rev. Rul. 69-486, 1969-2 C.B. 159 (ruling that taxable exchange results from non-pro-rata in-kind distribution of trust property where trustee had no authority to make a non-pro-rata distribution to trust beneficiaries).

[227] *See* I.R.C. § 662(a).

[228] *See* I.R.C. § 661(a).

[229] *See*, *e.g.*, I.R.S. Priv. Ltr. Rul. 200723014 (Feb. 5, 2007) (ruling that non-pro-rata division of trust would not result in a distribution for purposes of sections 661 and 662); I.R.S. Priv. Ltr. Rul. 200607015 (Nov. 5, 2005) (ruling that trustee's appointment of trust property from four trusts to four new trusts that changed administrative provisions and governing law would not result in realization of income, gain, or loss to original or resulting trusts or trust beneficiaries under sections 661 and 662).

[230] *See*, *e.g.*, Crane v. Comm'r, 331 U.S. 1 (1947).

[231] *See* Treas. Reg. § 1.1001-2(a)(4)(v) (as amended in 2007); *see also* I.R.C. § 752(d).

[232] *See Crane*, 331 U.S. at 14.

the extent of the negative partnership capital account.[233] However, situations may arise in which these general rules do not apply in the case of a decanting from one trust to another trust.

Generally, Code section 643(e) protects against recapture gain unless the trustee elects to recognize gain.[234] The issue then becomes whether the nonrecognition rule of Code section 643(e) trumps Code sections 752 and 1001.[235] These issues can arise in the following scenarios:

(1) A decanting of assets with recapture gain from a complex trust to a complex trust.

(2) A decanting of assets with recapture gain from a complex trust to a grantor trust. In this case, section 643(e) may protect the transfer from gain recognition because that section applies to transfers from complex trusts.[236]

(3) A decanting of assets with recapture gain from a grantor trust to a complex trust. Care should be taken when decanting assets from a grantor to a non-grantor trust because the decanting may result in taxable income to the grantor. Where grantor trust status is released, terminated or expires during the grantor's lifetime, for income tax purposes the grantor is treated as having transferred assets to the trust, and the following tax consequences may occur: (1) the grantor's amount realized may include the amount of liabilities of the trust which the grantor is no longer treated as owning;[237] and (2) under the partnership rules, the grantor recognizes gain to the extent that partnership liabilities exceed the trust's basis in the partnership interest.[238] Example 5 of Treasury Regulation section 1.1001-2(c) describes this fact pattern.[239] The Service included this example in the regulations to prevent taxpayers with "burned out" tax shelters with liabilities in excess of basis from avoiding recapture of the gain by placing the burned out tax shelters in a grantor trust and then releasing the powers that caused the trust to be a grantor trust, thereby converting the grantor trust to a complex trust.

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[233] *See* I.R.C. § 752(d).

[234] *See* I.R.C. § 643(e).

[235] *See* Alan S. Acker, 852-3d T.M. *Income Taxation of Trusts and Estates*, A-103 (2007).

[236] *See* I.R.C. § 643(e).

[237] *See* I.R.S. Tech. Adv. Mem. 200011005 (holding that where GRAT borrows funds from another trust to make annuity payments to grantor, grantor is treated as having disposed of assets to GRAT upon cessation of grantor trust status and the grantor's amount realized includes the GRAT's liabilities no longer treated as owned by the grantor).

[238] *See Madorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul. 77-402; Treas. Reg. § 1.1001-2(c), ex. 5.

[239] *See* Treas. Reg. § 1.1001-2(c) ex. 5.

The example provides that once the trust ceases to be a grantor trust, the grantor is deemed to have transferred the partnership interest to a complex trust, which is treated as a separate entity.[240] Upon the deemed transfer, the grantor realizes taxable gain to the extent the grantor is relieved of partnership liabilities in excess of the grantor's basis in the partnership interest. Code section 643(e) would not protect this gain because that section does not apply to grantor trusts.[241]

V. STATUTORY REQUIREMENTS FOR DECANTING

As of the date of this Article, ten states have adopted decanting statutes: Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, New York, North Carolina, South Dakota, and Tennessee.[242] Although the state decanting statutes vary with respect to the detail or requirements provided for when and to what extent a trustee may exercise a discretionary distribution power by appointing property to another trust, to some extent each of the statutes contains language similar to that provided in the statutes of other states. With the exception of New York, however, all statutes are in the same position with respect to construction—there are no cases interpreting or construing the statutory provisions governing decanting. Moreover, the cases that analyze New York's decanting statute provide limited guidance on the construction or interpretation of the statute.[243]

A. Trustee's Discretionary Authority to Distribute Trust Property

The trustee's discretionary authority to make distributions to or for the benefit of trust beneficiaries provides the premise for the various state decanting statutes, and the statutes clarify that the power to distribute includes

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240 *See id.*

241 *See* I.R.C. § 643(e).

242 *See* ALASKA STAT. § 13.36.157 (2008); ARIZ. REV. STAT. ANN. § 14-10819 (2005); DEL. CODE ANN. tit. 12, § 3528 (2007); FLA. STAT. ANN. § 736.04117(1)(a) (West Supp. 2008); 2009 Nev. Stat. 782 (enacting trust decanting provisions in Chapter 163 of the Nevada Revised Statutes); N.H. REV. STAT. ANN. § 564-B:4-418 (LexisNexis Supp. 2009); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002); N.C. GEN. STAT. § 36C-8-816.1 (2009); S.D. CODIFIED LAWS § 55-2-15 (Supp. 2008); TENN. CODE ANN. § 35-15-816 (2007).

243 *See, e.g.*, *In re* Estate of Mayer, 672 N.Y.S.2d 998 (N.Y. Surr. Ct. 1998) (holding that "sole and absolute discretion" to invade pursuant to ascertainable standard does not constitute absolute discretion to invade for purposes of decanting statute); *In re* Dornbush, 627 N.Y.S.2d 232 (N.Y. Surr. Ct. 1995) (considering transfer of property to substantially identical trusts in another jurisdiction to shield trusts from state real property transfer gains tax); *In re* Kaskel, 620 N.Y.S.2d 217 (N.Y. Surr. Ct. 1994) (discussing decanting of property from a spendthrift trust to another trust without spendthrift provisions).

the power to transfer assets in further trust for the benefit of the trust's beneficiaries.[244] A testamentary instrument or an irrevocable *inter vivos* trust agreement must contain the discretionary authority to distribute assets,[245] although some statutes merely provide that the discretionary power must exist under a trust or a trust established under an irrevocable trust instrument.[246]

Although a few decanting statutes require that the trustee's power or discretion to distribute principal must be "absolute,"[247] most of the statutes merely require that the trustee have the authority or discretion to distribute property.[248] The law is unclear, however, on whether a trustee may decant property to another trust where the discretionary power to distribute is limited by an ascertainable standard. For example, Delaware's decanting statute requires that the exercise of the power to decant must comply with any standard that limits the trustee's authority to make distributions from the first trust.[249] In general, a transfer of property to another trust would not seem to comply with an ascertainable standard governing distributions to trust beneficiaries. Situations may arise, however, where a trust decanting would be in furtherance of a beneficiary's health, education, support, or maintenance in the beneficiary's accustomed manner of living. In an apparent attempt to clarify the scope of discretion necessary for a trustee to decant, North Carolina's statute expressly allows a decanting pursuant to an ascertainable standard if certain conditions are met.[250]

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[244] *See supra* note 242.

[245] *See, e.g.*, ARIZ. REV. STAT. ANN. § 14-10819(A) (2005); DEL. CODE ANN. tit. 12, § 3528(a) (2007); 2009 Nev. Stat. 782; N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b)(1) (McKinney 2002); S.D. CODIFIED LAWS § 55-2-15 (Supp. 2008); TENN. CODE ANN. § 35-15-816(27)(A) (2007).

[246] *See, e.g.*, ALASKA STAT. § 13.36.157(a) (2008); FLA. STAT. ANN. § 736.04117(1)(a) (West Supp. 2008); N.H. REV. STAT. ANN. § 564-B:4-418(a) (LexisNexis Supp. 2009); N.C. GEN. STAT. § 36C-8-816.1(a) (2009).

[247] *See* FLA. STAT. ANN. § 736.04117(1)(a) (West Supp. 2008); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b)(1) (McKinney 2002); *see also In re* Mayer, 672 N.Y.S.2d at 999–1001 (holding that "sole and absolute discretion" to invade pursuant to ascertainable standard does not constitute absolute discretion to invade for purposes of decanting statute).

[248] *See, e.g.*, ALASKA STAT. § 13.36.157(a) (2008); ARIZ. REV. STAT. ANN. § 14-10819(A) (2005); DEL. CODE ANN. tit. 12, § 3528(a) (2007); 2009 Nev. Stat. 782; N.H. REV. STAT. ANN. § 564-B:4-418(a) (LexisNexis Supp. 2009); N.C. GEN. STAT. § 36C-8-816.1(b) (2009); S.D. CODIFIED LAWS § 55-2-15 (Supp. 2008); TENN. CODE ANN. § 35-15-816(27)(A) (2007).

[249] *See* DEL. CODE ANN. tit. 12, § 3528(a)(5) (2007).

[250] *See* N.C. GEN. STAT. § 36C-8-816.1(b), (c)(7) (2009) (providing that trustee may decant whether or not there is a current need to distribute property under any standard

Regardless of whether one decants pursuant to a discretionary power that is absolute or limited to an ascertainable standard, the trustee presumably would be subject to fiduciary duties when exercising the power. South Dakota's decanting statute expressly provides that a trustee must decide that the decanting 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."[251]

Some decanting statutes authorize the appointment of only trust principal in further trust,[252] while others permit a decanting of either trust income or principal.[253] The more recent decanting statutes, however, either prohibit or limit the ability to decant property subject to a presently exercisable withdrawal power of a beneficiary, which may be aimed at preventing an inadvertent taxable gift upon the lapse of a presently exercisable withdrawal right resulting from a decanting.[254]

The more recent decanting statutes also appear to be aimed at preventing a potential taxable gift by a trustee by limiting the ability to decant when the trustee is a beneficiary of the trust.[255] In addition, most of the decanting statutes recognize that the power to decant may exist under the terms of the trust instrument or common law and provide that the statutory decanting power does not abridge such other sources of a trustee's decanting authori-

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provided in original trust, but if power to distribute is subject to ascertainable standard, then second trust must be subject to same ascertainable standard exercisable in favor of same current beneficiaries as original trust); *see also* ALASKA STAT. § 13.36.157(a), (a)(4) (1998) (providing that trustee may decant whether or not there is a current need to invade principal under any standard in governing instrument, but appointed trust must contain same standard for invading principal as standard contained in invaded trust).

[251] S.D. CODIFIED LAWS § 55-2-15 (Supp. 2008).

[252] *See, e.g.*, ALASKA STAT. § 13.36.157(a) (2008); DEL. CODE ANN. tit. 12, § 3528(a) (2007); FLA. STAT. ANN. § 736.04117(1)(a) (West Supp. 2008); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b)(1) (McKinney 2002); TENN. CODE ANN. § 35-15-816(27)(A) (2007).

[253] *See, e.g.*, 2009 Nev. Stat. 782; N.C. GEN. STAT. § 36C-8-816.1(a) (2009); S.D. CODIFIED LAWS § 55-2-15 (Supp. 2008). The decanting statutes of New Hampshire and Arizona do not distinguish between trust principal or income that may be distributed to another trust. *See* ARIZ. REV. STAT. ANN. § 14-10819(A) (2005); N.H. REV. STAT. ANN. § 564-B:4-418(a) (LexisNexis Supp. 2009).

[254] *See*, *e.g.*, 2009 Nev. Stat. 782; N.H. REV. STAT. ANN. § 564-B:4-418(b)(4) (LexisNexis Supp. 2009); N.C. GEN. STAT. § 36C-8-816.1(c)(6) (2009); S.D. CODIFIED LAWS § 55-2-15(5) (Supp. 2008).

[255] *See*, *e.g.*, 2009 Nev. Stat. 782; N.H. REV. STAT. ANN. § 564-B:4-418(c) (LexisNexis Supp. 2009); N.C. GEN. STAT. § 36C-8-816.1(d) (2009); S.D. CODIFIED LAWS § 55-2-15(2)(a), (b) (Supp. 2008). It may be possible, however, for the remaining cotrustees or a specially appointed fiduciary to authorize a decanting.

ty.[256] For those states with decanting statutes that do not expressly recognize the trustee's ability to decant under the terms of the trust instrument or state common law, it is unclear whether a trust decanting must comply at all times with the restrictions or limitations imposed by statute.[257]

B. Permissible Appointee Trusts and Beneficiaries

A few states expressly allow the trustee to decant property in favor of a trust (appointee trust) created under the same trust instrument or a different trust instrument.[258] However, a majority of the statutes appear to limit the decanting of property to a trust under an instrument other than the instrument under which the power to invade principal was created.[259] In addition, North Carolina's decanting statute expressly provides that the trustees' power to decant includes the power to create the second trust,[260] and Nevada's decanting statute permits the trustees exercising the decanting power to designate themselves or any other person permitted to act as trustee as trustee of the second trust.[261] South Dakota's decanting statute specifically provides that trust property may be decanted to another trust created or administered under the laws of any jurisdiction.[262]

Older state decanting statutes provide that a trust decanting must be exercised in favor of the proper objects of the exercise of the power.[263] The result of this requirement is that the beneficiaries of the appointee trust may include only persons who are proper objects of the trustee's exercise of the

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[256] *See*, *e.g.*, FLA. STAT. ANN. § 736.04117(7) (West Supp. 2008); 2009 Nev. Stat. 782; N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(g) (McKinney 2002); N.C. GEN. STAT. § 36C-8-816.1(g) (2009).

[257] *See*, *e.g.*, ALASKA STAT. § 13.36.157 (2008); ARIZ. REV. STAT. ANN. § 14-10819 (2005); N.H. REV. STAT. ANN. § 564-B:4-418 (LexisNexis Supp. 2009).

[258] *See* FLA. STAT. ANN. § 736.04117(1)(a) (West Supp. 2008); N.C. GEN. STAT. § 36C-8-816.1(b) (2009).

[259] *See*, *e.g.*, ALASKA STAT. § 13.36.157(a) (2008); ARIZ. REV. STAT. ANN. § 14-10819(A) (2005); DEL. CODE ANN. tit. 12, § 3528(a) (2007); N.H. REV. STAT. ANN. § 564-B:4-418(a) (LexisNexis Supp. 2009); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b)(1) (McKinney 2002); S.D. CODIFIED LAWS § 55-2-15 (Supp. 2008); TENN. CODE ANN. § 35-15-816(27)(A) (2007).

[260] *See* N.C. GEN. STAT. § 36C-8-816.1(b) (2009).

[261] *See* 2009 Nev. Stat. 782.

[262] *See* S.D. CODIFIED LAWS § 55-2-15 (Supp. 2008).

[263] *See* DEL. CODE ANN. tit. 12, § 3528(a)(1) (2007); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b)(1) (McKinney 2002); TENN. CODE ANN. § 35-15-816(27)(A)(ii) (2007). Under the Delaware decanting statute, the second trust may continue for the beneficiaries of the first trust under substantially identical terms as the first trust after a specified time or event. *See* DEL. CODE ANN. tit. 12, § 3528(a) (2007) (flush language).

discretionary power to invade principal. The reference to "proper objects of the exercise of the power" is not defined by statute, and alternatively, could refer to the class of discretionary beneficiaries under the trustee's power to invade—the settlor's issue, or only those beneficiaries to or for the benefit of whom the trustee could have distributed trust principal on the date of the trust decanting (for example, the settlor's issue then living on the date of the decanting). It would appear, however, that the better interpretation would be to allow future or contingent beneficiaries of the appointee trust to include any person or class designated as future or contingent beneficiaries in the first trust, without limiting the appointee trust's beneficiaries to only those beneficiaries who actually could have received discretionary distributions of principal on the date of the decanting. This interpretation would be in line with the original purpose of New York's decanting statute[264] and the position taken by the *Second* and *Third Restatements* with respect to a powerholder's ability to exercise a special power by appointing property in further trust for the benefit of permissible appointees.[265]

The more recent decanting statutes describe the permissible appointees of a trustee's power to distribute property in terms of trust "beneficiaries" rather than proper objects of the exercise of the power.[266] A few state statutes further distinguish between current beneficiaries, those who are currently permissible distributees of trust property, and other beneficiaries—those who only have a future interest, be it vested or contingent.[267] It appears, therefore, that beneficiaries of the appointee trust could include either beneficiaries currently in being at the time of the decanting, or some or all

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[264] *See* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002) (Practice Commentary) (providing decanting statute was "[a]t first enacted to allow trustees to take advantage of generation-skipping transfer tax advantages").

[265] *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 19.4 cmt. b, illus. 5 (1986) (illustrating that donee of special power of appointment under testamentary trust exercisable in favor of one or more of donor's issue may exercise power in favor of a trust for the benefit of a specified child of donor and such child's issue for the child's life in trustee's discretion, then to the child's issue then living at child's death); RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 19.14 cmt a, illus. 1 (Tentative Draft No. 5, 2006) (illustrating that donee of special power to appoint to one or more of donor's issue may appoint property to trust for the benefit of donor's child for life with remainder to child's issue then living).

[266] *See, e.g.*, ARIZ. REV. STAT. ANN. § 14-10819(A)(3) (2005); 2009 NEV. STAT. 782; N.H. REV. STAT. ANN. § 564-B:4-418(a) (LexisNexis Supp. 2009); N.C. GEN. STAT. § 36C-8-816.1(a)–(c) (2009).

[267] *See, e.g.*, FLA. STAT. ANN. § 736.04117(1)(a) (West Supp. 2008); 2009 Nev. Stat. 782; N.C. GEN. STAT. § 36C-8-816.1(a)–(c) (2009).

of the class of beneficiaries in whose favor the decanting power could be exercised.

Statutory limitations on the permissible beneficiaries of the appointee trust may have other consequences. For example, a consistent theme among the state decanting statutes (except South Dakota) is the prohibition against accelerations of remainder interests to current beneficial interests as a result of decanting. The decanting statutes of Delaware, New York, and Tennessee appear to prohibit the acceleration of a remainder interest in an original trust to a current beneficial interest in the appointee trust because beneficiaries of the appointee trust are limited to the proper objects of the exercise of the power—the current permissible distributees of the trustee's discretionary power to make distributions.[268] North Carolina's decanting statute expressly prohibits the acceleration of a future beneficial interest in the appointee trust.[269]

Decanting statutes place various restrictions on the terms of the appointee trust with respect to standards of distribution, such as requiring the appointee trust to contain the same standard or restrictions on distributions as the original trust.[270] For example, North Carolina provides that if a trustee decants pursuant to a discretionary power to distribute that is limited by an ascertainable standard, the power to distribute under the appointee trust must be subject to the same ascertainable standard and be exercisable in favor of the same current beneficiaries as provided in the original trust.[271] The policy behind these rules may be that where a settlor includes an ascertainable standard in a trust, the settlor intends to limit the trustee's discretion to distribute trust property; therefore, the statute should similarly limit the trustee's discretion to decant.

The vast majority of state decanting statutes prohibit the reduction of the fixed income interest of a beneficiary under the original trust as a result of a decanting. The trend among more recent decanting statutes is to also include prohibitions against reductions to fixed annuity or unitrust interests

[268] *See* DEL. CODE ANN. tit. 12, § 3528(a)(1) (2007); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b)(1) (McKinney 2002); TENN. CODE ANN. § 35-15-816(27)(A)(ii) (2007).

[269] *See* N.C. GEN. STAT. § 36C-8-816.1(c)(2) (2009).

[270] *See, e.g.*, ALASKA STAT. § 13.36.157(a)(4) (2008) (second trust must contain same standard for invading principal as invaded trust); ARIZ. REV. STAT. ANN. § 14-10919 (2005) (recipient trust must contain same or more restrictive ascertainable standard for distributions as first trust when trustee exercising the decanting is a possible beneficiary under the standard); S.D. CODIFIED LAWS § 55-2-15(2)(b) (Supp. 2008) (second trust may not remove restrictions on discretionary distributions imposed under first trust unless special rules apply).

[271] *See* N.C. GEN. STAT. § 36C-8-816.1(c)(7) (2009).

and protections for marital or charitable deductions or gift tax exclusions afforded under the terms of the original trust.[272] Additionally, a few of the decanting statutes clarify that the appointee trust may give a general or special power of appointment to discretionary beneficiaries of the original trust, and permissible appointees of the power potentially may include persons other than discretionary beneficiaries of the original trust.[273]

C. Procedural Requirements and Mechanics of Decanting

In general, the exercise of the special power to appoint property to another trust must be in a writing that is signed and acknowledged by the trustee and kept with the records of the original trust, and the trustee may be required to give notice to the beneficiaries before the effective date of the proposed decanting.[274] Under the New York decanting statute, the trustee must file a signed and notarized writing with the clerk of court that has jurisdiction over the trust, a copy of which must be served upon all persons interested in the trust.[275] The decanting statutes of Alaska and Arizona are silent with respect to the procedural requirements for a decanting,[276] but it may be advisable to provide notice to the beneficiaries and retain a copy of the decanting documents with the records of the trust.

In substance, the documents employed for a trust decanting should be similar to those used with respect to a resolution to distribute property or a trust merger. A written document providing the terms of the trustee's discretionary exercise of the power to decant should set forth the terms of the exercise of the power to appoint trust property further in trust. Generally, the document should set forth background information or recitals identifying (1) the current trustees of the original trust and the trustees that are exercising the decanting power; (2) when the original trust was formed and by whom; (3) the relevant terms of the original trust; (4) the trustee's authority for the decanting, whether pursuant to statute or the trust instrument; and (5) the appointee trust that will receive trust property from the original trust. The decanting document also should include trustee resolutions designating and appointing assets of the original trust to the appointee trust and direct-

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272 *See*, *e.g.*, ARIZ. REV. STAT. ANN. § 14-10819(A)(1)–(2), (5) (2005); FLA. STAT. ANN. § 736.04117(1)(a)(2), (3) (West Supp. 2008); 2009 Nev. Stat. 782; N.H. REV. STAT. ANN. § 564-B:4-418(b)(2), (3) (LexisNexis Supp. 2009); N.C. GEN. STAT. § 36C-8-816.1(c)(3), (4) (2009).

273 *See*, *e.g.*, 2009 Nev. Stat. 782; N.C. GEN. STAT. § 36C-8-816.1(c)(8) (2009).

274 *See*, *e.g.*, FLA. STAT. ANN. § 736.04117(2)(4) (West Supp. 2008); 2009 Nev. Stat. 782; N.C. GEN. STAT. § 36C-8-816.1(f) (2009); S.D. CODIFIED LAWS § 55-2-18 (Supp. 2008).

275 *See* N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(d) (McKinney 2002).

276 *See* ALASKA STAT. § 13.36.157 (2008); ARIZ. REV. STAT. ANN. § 14-10819 (2005).

ing that the appointed assets be held in accordance with the terms of the appointee trust.[277]

As a preliminary matter, property of the original trust must be transferred to an appointee trust that is in existence and has a currently acting trustee able to take legal title to the property. The appointee trust may be a trust already in existence and operation at the time of the transfer, or a newly created trust funded with the property received from the original trust. For example, North Carolina's decanting statute provides that: (1) the second trust can be a currently existing trust created in the past by the settlor of the original trust or by a third party;[278] (2) the second trust can be a new trust created by the settlor of the original trust or by a third party in contemplation of the current decanting;[279] or (3) the second trust can be a new trust created by the trustee of the original trust, for example, under the terms of the original trust instrument, the terms of another trust instrument, or by declaration of trust.[280]

D. Beneficiary Consent and Court Approval

Although a majority of the decanting statutes do not expressly require beneficiary consent or court approval for the decanting to be effective, several decanting statutes permit a trustee or beneficiary to seek court approval.[281] The Nevada decanting statute requires the beneficiary's written consent if the "property specifically allocated for one beneficiary of the original trust is no longer allocated for that beneficiary under either or both trusts [the original trust or second trust]."[282]

A beneficiary's release and indemnification with respect to a trust decanting potentially could result in adverse tax consequences to the beneficiary if the Service takes the position that the release and indemnification is tantamount to the beneficiary's consent. A beneficiary's required consent to a trust decanting could result in a taxable gift by the beneficiary[283] or ad-

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[277] *See supra* notes 272–72 and accompanying text.

[278] *See* N.C. GEN. STAT. §§ 36C-4-401(1), 36C-8-816.1(a)(2) (2009).

[279] *See id.*

[280] *See* N.C. GEN. STAT. §§ 36C-4-401(1), 36C-8-816.1(a)(2), (b) (2009).

[281] *See, e.g.*, ARIZ. REV. STAT. ANN. § 14-10819(D) (2005) (trustee may request court approval prior to or after exercise of statutory decanting power); 2009 NEV. STAT. 783; (trustee may petition court for approval before appointing property to another trust pursuant to decanting statute); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(b)(2) (McKinney 2002) (trustee may seek prior court approval); N.C. GEN. STAT. § 36C-8-816.1(h) (2009) (trustee or beneficiary may commence proceeding to approve or disapprove proposed decanting).

[282] *See* 2009 Nev. Stat. 782. Nev. 2009 Session Law, S.B. 287, § 37.2(e).

[283] *See* discussion at *supra* Part IV.B.

verse GST consequences.[284] A beneficiary's consent also could raise the issue of whether a taxable exchange occurred for income tax purposes.[285] Trust beneficiaries should not consent to a decanting unless the only differences between the first trust and the second trust are administrative or it is otherwise clear that there has been no shift in beneficial interests.

As a general matter, the settlor of the original trust should refrain from agreeing to indemnify the trustee from any liability that may arise from decanting property from the original trust to the second trust. An indemnification may create the appearance of an implied agreement that the trustee would carry out the settlor's wishes, which could result in the inclusion of trust property in the settlor's estate under Code sections 2036 and 2038.[286]

As an alternative, a trustee could minimize liability through a receipt and refunding agreement entered into with the second trust and its beneficiaries with respect to the original trust property used to fund the second trust. While a receipt and refunding agreement usually is desirable, such an agreement is only effective to the extent that the second trust or its beneficiaries either retain the property subject to the agreement or have the financial ability to replace the value of such property.

E. Changing a Trust's Situs or Governing Law

In certain situations it may be advantageous to move a trust from one state to another to take advantage of a more favorable decanting statute. Changing the governing law of a trust to a state with favorable common law on trust decanting could provide additional opportunities. The following paragraphs describe some of the major differences between the state decanting statutes and offer some suggestions as to when it may be advisable to change the situs of a trust to take advantage of favorable provisions in another state's decanting statute.

Trust decanting may be used to take advantage of the effective date of another state's decanting statute. Under Safe Harbor #1, a transfer of property from a grandfathered trust to a second trust will not be treated as a modification of the original trust for GST tax purposes as long as the trustee decanted pursuant to the authority provided in the trust instrument or state law that existed at the time the original trust was created.[287] Private letter rulings have applied these regulations to ZIR trusts, and it may be possible to move the situs of a trust to take advantage of a decanting statute in anoth-

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284 *See* discussion at *supra* Part IV.A.
285 *See* discussion at *supra* Part IV.C.
286 *See* I.R.C. §§ 2036, 2038.
287 *See supra* Part IV.A.1.b.

er state that was enacted at or before the time of the ZIR trust's creation to take advantage of the regulatory safe harbor.[288]

Additionally, changes to a trust's situs may deal effectively with the various statutory restrictions imposed on the ability to decant. As previously mentioned, states such as New York and Florida require absolute discretion to make a distribution of trust principal as a prerequisite for decanting.[289] However, other statutes merely require a trustee to have the discretionary authority to distribute trust property, whether principal or income, to or for the benefit of trust beneficiaries.[290] Moreover, it may be possible to change the situs of a trust to a state with a statute that permits a decanting even if the trustee's authority to make discretionary distributions is limited by an ascertainable standard.[291]

Decanting also could be used to address differences among the perpetuities rules. For example, if one contributes real property that is located in a state that applies the common law rule against perpetuities to a perpetual trust that is valid under another state's governing law, the perpetual trust could decant the real property to another trust that complies with the perpetuities rules of the state in which the real property is located.[292] In some circumstances, it also may be possible to decant property from a trust governed by the common law rule against perpetuities to a trust administered in and governed by the law of a state that has repealed the common law rule.[293]

The validity of a decanting that changes the place of administration and governing law of a trust will be determined under the choice of law rules applicable to the trust before and after the decanting. Therefore, practitioners should be aware of such rules. For example, the *Second Restatement of Conflict of Laws* provides that a trust of personal property is construed in accordance with the rules of the state designated under the terms of the gov-

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[288] *See supra* Part IV.A.2.a.

[289] *See supra* note 247 and accompanying text.

[290] *See supra* note 248 and accompanying text.

[291] *See*, *e.g.*, ARIZ. REV. STAT. ANN. § 14-10819(A)(4) (2005); 2009 Nev. Stat. 782; N.C. GEN. STAT. § 36C-8-816.1(c)(7) (2009).

[292] *See*, *e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS: TRUSTS § 278 (1971) ("The validity of a trust of an interest in land is determined by the law that would be applied by the courts of the situs.").

[293] *See*, *e.g.*, DEL. CODE ANN. tit. 12, § 3332(a) (2007) ("The 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."). *But see* S.D. CODIFIED LAWS § 55-2-20 (Supp. 2008) (providing that 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").

erning instrument,[294] and the administration of an *inter vivos* trust of personal property is governed by the local law of the state designated by the settlor to govern the trust's administration.[295] The law of the state designated to govern the trust's validity determines the validity of an *inter vivos* trust of personal property, provided that the state has a substantial relation to the trust and the application of its law does not violate a strong public policy of the state in which the trust has the most significant relationship to the matter at issue.[296] If the terms of the trust do not designate the law governing rules of construction, the trust is construed in accordance with the law of the state governing the trust's administration with respect to matters of trust administration and, as to matters not pertaining to administration, in accordance with the rules of construction of the state the settlor probably would have preferred.[297] If the terms of the trust do not designate the law governing the trust's administration or validity, the administration or validity of the trust is determined according to the law of the state with the most significant relationship to the trust with respect to the matter at issue.[298]

Similar to the *Second Restatement of Conflict of Laws*, the UTC provides that the meaning and effect of the terms of a trust are determined by the law of the jurisdiction designated under the terms of the trust, unless that jurisdiction's law is contrary to a strong public policy of the jurisdiction with the most significant relationship to the matter at issue.[299] In the absence of a controlling designation in the terms of the trust, the state with the most significant relationship to the matter at issue determines the meaning and effect of the terms of the trust.[300] The provisions of the *Second Restatement of Conflict of Laws* and the UTC appear to strike a balance between having the law of a single jurisdiction govern the validity or administration of a trust and allowing a state to uphold clearly stated matters of public policy relating to trusts where the state has the most significant relationship to the trust matter at issue. The statutory or common law regarding choices of law governing a trust or its administration, however, may vary significantly

[294] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS: TRUSTS § 268(1) (1971).
[295] *See id.* § 272(a).
[296] *See id.* § 270(a).
[297] *See id.* § 268(2).
[298] *See id.* §§ 270(b), 272(b).
[299] *See* UNIF. TRUST CODE § 107(1) (2000), 7C U.L.A. 436 (2006).
[300] *See id.* § 107(2), 7C U.L.A. 436 (2006).

from state to state, and practitioners should investigate a state's choice of law principles when considering a trust decanting.[301]

VI. FIDUCIARY ISSUES & PRACTICAL CONSIDERATIONS

A. Fiduciary Issues

It is well established that a trustee owes fiduciary duties to trust beneficiaries. Unlike a power of appointment held in a nonfiduciary capacity, a trustee's decision to decant is subject to fiduciary obligations and may not be arbitrary. For example, although a run-of-the mill power of appointment held by the settlor's spouse may be exercised properly, in a legal sense, to exclude illegitimate children as beneficiaries of the trust, the same course of action would be questionable if undertaken by a trustee who owes fiduciary duties to the children as trust beneficiaries.

Generally, trustees will be reluctant to decant assets to another trust if they believe trust beneficiaries will second-guess their actions. A trustee's typical course of action to obtain a release and indemnification by the beneficiaries may not be advisable in a decanting situation because it could raise a number of adverse tax implications for the trust or its beneficiaries.[302] Also, an indemnification by the settlor may raise concerns of an implied agreement that the settlor controls the actions of the trustee and attending estate tax implications.[303] One option is for the trustees to obtain court approval for the desired action, but the trustee should be aware of the potential tax consequences of obtaining court approval.[304] Generally, however, courts will defer to a trustee's discretion in the absence of an abuse of discretion—the heightened standard used for imposing liability on trustees in the exercise of their discretionary authority.[305] Trustees also should take comfort in the flexibility that decanting affords to create a wide array of scenarios that are consistent with the trustee's fiduciary duties in a given situation.

B. Practical Considerations

It generally is recommended that decanting provisions be included in the trust agreement so the trustee will not have to rely on the decanting sta-

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[301] For a general discussion of conflict of law issues involving trusts, see GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEE § 301 (2d ed. 1992).

[302] *See generally* discussion *supra* Parts IV, V.D.

[303] *See generally* discussion *supra* Part IV.B.

[304] *See generally* discussion *supra* Part V.D.

[305] *See generally* RESTATEMENT (SECOND) OF TRUSTS § 187 (1959) (discussing control by court of trustee's discretionary powers).

tute. One could draft a custom decanting provision to fit the particular needs or circumstances surrounding a trust. Decanting provisions can also be drafted to provide the trustee with the flexibility to respond to changed circumstances with respect to the trust or trust beneficiaries, and to supply guidance to the trustee as to the settlor's intent regarding the trustee's exercise of the decanting power.

As further discussed below, sometimes it may be better to amend or modify an existing trust, if possible, rather than decant to another trust.[306] A trust modification could protect the trustee from liability because state statutes modeled after the UTC generally do not require the trustee's consent or participation for a trust modification.

It also may be helpful to consider giving a third party the ability to exercise the power to distribute property to another trust under the terms of the trust instrument. However, practitioners should consider the fiduciary duties under state law owed by third persons holding powers to direct the trustee. For example, North Carolina law generally presumes that a person other than a beneficiary that has the power to direct the trustee is a fiduciary.[307] The drafter should consider whether the trust should provide specifically that the third party holds the power to decant in a nonfiduciary capacity.

VII. COMPARISON TO TRUST MODIFICATIONS, MERGERS, OR DIVISIONS

Several provisions of the UTC provide for modifications, mergers, or divisions of trusts under certain circumstances. As compared to trust decanting statutes, changes to trusts pursuant to these provisions generally are more restrictive or require approval of a court or all beneficiaries. It is also important to check for any state specific modifications that may have been made to the particular version of the UTC applicable to the trust.

A. Trust Modifications and Reformations

The UTC provides that a noncharitable irrevocable trust may be modified with the consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.[308] If the settlor or beneficiaries seek court approval of a modification by consent, the court must grant the approval.[309] Modification by consent presum-

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[306] *See* discussion *infra* Part VII.A.

[307] *See* N.C. GEN. STAT. § 36C-8-808(d) (2009) (providing that nonbeneficiary's power to direct trustee is presumed to be a fiduciary power).

[308] *See* UNIF. TRUST CODE § 411(a) (amended 2004), 7C U.L.A. 497–98 (2006).

[309] *See id.*, 7C U.L.A. 497–98 (2006).

ably requires the consent of all beneficiaries, including contingent remainder beneficiaries. While virtual representation is permitted, it may still be difficult to obtain the consent of all beneficiaries.

If the settlor is deceased or otherwise unavailable, an irrevocable trust may be modified with the consent of all beneficiaries if the court concludes that modification is consistent with a material purpose of the trust.[310] If the consent of all beneficiaries cannot be obtained, a court may approve a proposed modification of a trust if it finds that the trust could have been modified if all of the beneficiaries had consented and the interests of nonconsenting beneficiaries will be adequately protected.[311]

If, because of circumstances not anticipated by the settlor, modification or termination would further the purposes of a trust, a court may modify the administrative or dispositive terms of a trust in accordance with the settlor's probable intention.[312] The UTC provisions state that "[t]he court may [also] modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration."[313]

A court may modify "a trust in a manner that is not contrary to the settlor's probable intention" to achieve the settlor's tax objectives, and the court additionally "may provide that the modification has retroactive effect."[314] A court also may reform "a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law."[315]

Unlike the UTC provisions governing trust modifications, state decanting statutes authorize a decanting of trust property to another trust in the trustee's discretion, and generally do not require the approval or consent of the settlor or beneficiaries.[316] Although a trustee or beneficiary may be able to seek court approval or disapproval of a proposed trust decanting, the court's approval would depend upon whether the proposed decanting was within the trustee's discretionary authority, presumably under the abuse of discretion standard.[317] Moreover, if decanting trust property to another trust would further the settlor's intent or purposes for the trust, trustees could

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[310] *See id.* § 411(b), 7C U.L.A. 498 (2006).
[311] *See id.* § 411(e), 7C U.L.A. 498 (2006).
[312] *See id.* § 412(a), 7C U.L.A. 507 (2006).
[313] *See id.* § 412(b), 7C U.L.A. 507 (2006).
[314] *Id.* § 416, 7C U.L.A. 516 (2006).
[315] *Id.* § 415, 7C U.L.A. 514–15 (2006).
[316] *See* Wareh, *supra* note 78, at 20. *See also* discussion at *supra* Part V.D.
[317] *See* RESTATEMENT (THIRD) OF TRUSTS § 87 (2007).

exercise their discretionary power without the additional costs or expenses incurred to obtain court approval.[318] The ability to modify a trust to achieve retroactively the settlor's tax objectives, however, would be beyond the discretionary authority of the trustee.[319]

Recently enacted statutes generally provide that the authority to decant does not create or imply a duty for the trustee to appoint property to another trust or an inference of impropriety from a trustee's failure to exercise the statutory decanting power.[320] Nevertheless, a fiduciary duty to decant may exist where state common law authorizes the decanting. Although the consent or approval of the trustee is not necessary for a modification under any of the UTC provisions, the *Third Restatement of Trusts* recognizes that under some circumstances a trustee may be under a duty to seek a court ordered trust modification.[321]

B. Trust Combinations and Divisions

The UTC permits a trustee to "combine two or more trusts" or "divide a trust into two or more separate trusts" if the trustee gives notice to the qualified beneficiaries and "the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust."[322] This provision allows a trustee to combine trusts even if their terms are not identical, such as by having different perpetuities periods.[323] The more that the dispositive provisions of the trusts differ, however, "the more likely it is that a combination would impair" a beneficiary's interest and thus decrease the likelihood that a combination can be achieved.[324] Generally, the UTC anticipates that divisions of trusts would result in multiple trusts with identical terms.[325]

North Carolina's version of the UTC provides that the assets of two or more trusts may be consolidated and administered "under the terms of one

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[318] *See* RESTATEMENT (THIRD) OF TRUSTS § 68 cmt. a (2003).

[319] *See* UNIF. TRUST CODE § 814 (amended 2004), 7C U.L.A. 620 (2006).

[320] *See*, *e.g.*, FLA. STAT. ANN. § 736.04117(6) (West Supp. 2008); N.H. REV. STAT. ANN. § 564-B:4-418(f) (LexisNexis Supp. 2009); N.C. GEN. STAT. § 36C-8-816.1(g) (2009).

[321] *See* RESTATEMENT (THIRD) OF TRUSTS § 66 cmt. e (2007) (providing circumstances when trustee is under a duty to seek modification or deviation from administrative of distributive provision of trust that would result in substantial harm to the trust or its beneficiaries or would jeopardize settlor's purpose for the trust); *see also id.* § 91 cmt. e, illus. 6 (duty of trustee to seek court ordered modification of trust or deviation from mandatory investment provisions that threaten settlor's purpose for the trust).

[322] UNIF. TRUST CODE § 417 (2000), 7C U.L.A. 517 (2006).

[323] *See id.* § 417 cmt., 7C U.L.A. 517 (2006). However, the shorter perpetuities would control the combined trust. *See* Treas. Reg. § 26.2601-1(b)(4)(i)(E) ex. 6.

[324] UNIF. TRUST CODE § 417 cmt., 7C U.L.A. 517 (2006).

[325] *See id.*, 7C U.L.A. 517 (2006).

of the trusts if the terms of the trusts are substantially similar and the beneficiaries of the trusts are identical."[326] Also, a trust may be divided into two or more trusts "if the new trusts provide in the aggregate for the same succession of interests and beneficiaries as are provided in the original trust."[327]

In contrast to trust combinations and divisions under the UTC, trust property generally may be decanted to a trust with substantially different administrative or dispositive terms (in absence of an ascertainable standard in most states) within the trustee's discretion.[328] Trust property may also be decanted to a trust that provides for a different succession of beneficial interests, and some or all of the beneficiaries of the original trust are not required to be beneficiaries of the second trust.[329] The exercise of a trustee's decanting authority, however, otherwise would remain subject to the trustee's fiduciary obligations.[330] Similarly, like the *Third Restatement of Trusts*, the UTC recognizes that under certain circumstances—such as the availability of substantial tax benefits from mergers or divisions of trusts—a trustee's failure to pursue a division may expose the trustee to liability for breach of fiduciary duties.[331]

VIII. CONCLUSION

The ability of a trustee to decant trust assets from one trust to another trust offers an additional dimension of flexibility in the administration of an irrevocable trust. Recently enacted decanting statutes are increasing the interests of trustees, beneficiaries and their advisors in this expanding area of trust law. Whenever a trust decanting is being considered, a complete understanding of the tax and non-tax issues that come into play is essential for practitioners looking to maximize the benefits and minimize the risks associated with the particular facts and circumstances of any given decanting.

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[326] N.C. GEN. STAT. § 36C-4-417(a)(1) (2009).
[327] N.C. GEN. STAT. § 36C-4-417(a)(2) (2009).
[328] *See* Wareh, *supra* note 78, at 19–20.
[329] *See id.* at 20.
[330] *See* RESTATEMENT (THIRD) OF TRUSTS § 86 cmt. b (2007).
[331] *See* UNIF. TRUST CODE § 417 cmt. (2000), 7C U.L.A. 517 (2006).