Strafford Publications Webinar

October 6, 2011

THE DELAWARE DECANTING STATUTE

Thomas R. Pulsifer
Morris Nichols Arsht & Tunnell LLP
1201 North Market Street
P. O. Box 1347
Wilmington, DE 19899-1347
Telephone: (302) 351-9226
Facsimile: (302) 425-4682
tpulsifer@mnat.com
www.mnat.com

Table of Contents

Page

I. Introduction ... 1

A. The Concept ... 1

B. Terminology ... 2

II. The Statute ... 2

A. Overview of How the Statute Works ... 2

B. Statutory Details ... 3

III. Mechanics ... 4

A. How Is "Decanting" Done ... 4

B. When Is Decanting Permitted ... 5

C. Protecting the Trustee ... 5

D. Ascertainable Standard ... 6

E. Governing Law Considerations ... 6

IV. Possible Uses of Decanting Statute ... 7

A. Alter Administrative Provisions ... 7

B. Clarify Ambiguous Provisions ... 8

C. Extend the Life of Trust ... 8

D. Create Subtrusts ... 9

E. Avoid State Income Tax ... 9

F. Grant Powers of Appointment ... 10

V. Generation-Skipping Transfer Tax Considerations ... 10

A. Treasury Reg. § 26.2601-1(b)(4)(i)(D) ... 10

The Delaware Decanting Statute

I. Introduction

A. The Concept

At least ten states (Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, New York, North Carolina, South Dakota and Tennessee) have enacted so-called "decanting statutes." The statutes vary in their details but the fundamental concept behind each is essentially the same in that all of the statutes permit trustees authorized to make outright distributions from a trust to instead make such distributions in further trust. The concept is simple but the implications and opportunities are immense and complex. This outline focuses entirely on Delaware's decanting statute. Delaware's decanting statute (12 Del. C. § 3528) permits trustees empowered to distribute trust principal outright to, or among, trust beneficiaries, whether the power is discretionary or exercisable pursuant to an enforceable distribution standard, to instead distribute trust assets to a different trust for the benefit of one or more of the beneficiaries to whom the trustee could have made an outright distribution. The practical opportunity (and customary use) afforded by this statute is to permit the trustee to make a distribution from a trust governed by an outdated trust instrument to a new trust governed by a modern trust instrument held upon beneficial terms substantially identical to the beneficial terms of the old trust. Thus, without in any way altering the trust's beneficial terms, a trust "trapped" in an old document can be "decanted" to a new vessel incorporating modern investment provisions, updated administrative provisions and other useful provisions without the necessity of a court-supervised reformation. However, this customary use of the decanting statute is no more than the tip of the iceberg, as the possible uses of the decanting statute are as varied and

numerous as the ideas that spring from the minds of thoughtful and creative trustees and their advisors.

B. Terminology

For convenience and ease of understanding, the term "first governing instrument" is used throughout this outline to refer to an existing trust instrument, including a trust agreement, Will, court order or any other document that creates a trust (referred to herein as the "first trust") from which assets may be distributed in further trust pursuant to the decanting statute. The term "second governing instrument" is intended to refer to whatever document created the trust (referred to herein as the "second trust") to which assets from the first trust may be distributed pursuant to the decanting statute. The second governing instrument might be a newly minted declaration of trust made by the trustee; could be a preexisting trust instrument that created a trust already in existence prior to the decanting transaction or could be the same document, that exercises the trustee's decanting power.

II. The Statute

A. Overview of How the Statute Works

In brief, the statute simply enables the trustee to make principal distributions in further trust when and to the extent that the trustee is empowered by the first governing instrument to make principal distributions outright. The statute does not address the possibility of decanting income so income may not be decanted as such. Of course, if the trustee is empowered to accumulate income and add it to principal, then, as a practical matter, income also may be decanted. Furthermore, if the first governing instrument requires income to be distributed, a trustee empowered to distribute principal outright could, subject to a special rule

for marital deduction trusts, decant to a second trust in which the income beneficiaries of the first trust are no longer eligible to receive income.

B. Statutory Details

The detailed rules of the statute work essentially like the rules of a board game. The trustee is empowered by the statute to craft the second governing instrument in whatever manner seems best to the trustee (abiding by the fiduciary duties, standard of care and distributing standards imposed upon the trustee by the first governing instrument) so long as the trustee does not violate any of the rules imposed by the statute as limitations upon the trustee's decanting power. One such rule is that the second trust must have only beneficiaries who were eligible to receive principal distributions from the first trust. So the trustee may not add new beneficiaries. However, the trustee may grant one or more general or limited powers of appointment to one or more beneficiaries of the first trust who were eligible to receive distributions from the first trust. As a result, the trustee and first trust beneficiaries collectively may fairly be said to possess the ability (without adverse transfer tax consequences) to cause the benefits of first trust property to be enjoyed by persons who were not beneficiaries of the first trust. Another of the statutory rules is that the trustee may provide in the second governing instrument that, at a time or upon an event specified in the second governing instrument, the assets of the second trust shall thereafter be held for the benefit of the beneficiaries of the first trust upon terms and conditions concerning the nature and extent of each such beneficiary's interest that are substantially identical to the first governing instrument's terms and conditions concerning such beneficial interests. This means, among other things, that all of the provisions of the first governing instrument regarding beneficiaries other than those currently eligible to receive distributions (such as those who may be eligible to receive distributions in the future and

remaindermen) may be preserved in the second governing instrument. However, the trustee may not add new current or non-current beneficiaries nor accelerate or otherwise alter the interests of the various non-current beneficiaries identified in the first governing instrument. So, for example, if the trustee is empowered by the first governing instrument to sprinkle distributions among the descendants of the settlor and the first governing instrument provides that the remaining trust assets pass to charity upon the death of the settlor's last living descendant, the trustee could create a second trust for the benefit of some (but less than all) of the settlor's descendants but could not provide for a distribution from the second trust to charity sooner than was permitted by the first governing trust (meaning no charity could take anything from the second trust so long as any descendant of the settlor remained living). The remaining rules are rules that prevent the trustee from (a) decanting from a revocable trust; (b) delaying the time that interests in a so-called "minor's trust" vest and become distributable; (c) decanting if the first governing instrument expressly forbids decanting; (d) reducing an income interest in a trust for which a marital deduction has been taken for federal estate or gift tax purposes; and (e) decanting property subject to a current withdrawal right held by a trust beneficiary who is the only beneficiary eligible for current distributions.

III. Mechanics

A. How Is "Decanting" Done

The Delaware statute provides that the decanting transaction whereby trust assets are distributed from one trust to another trust must be accomplished by an instrument in writing, signed and acknowledged by the trustee and filed with the records of the trust. In this instance, the statute seems plainly to refer to the records of the first trust but it seems evident the trustee (or the two trustees if the second trust's trustee is a different trustee) for both trusts ought to keep

a copy of this written instrument among the trust records. The statute mentions "acknowledgment," which means that the written instrument must be notarized. Beyond these few formalities, the trustee is left to the trustee's own devices to determine how best to arrange the mechanics of decanting transactions.

B. When Is Decanting Permitted

Unless the first governing instrument expressly prohibits decanting, a trustee may, under Delaware law, decant whenever the trustee has authority to make outright principal distributions whether or not the trustee's distribution power is limited by an ascertainable standard but only to the extent that trust principal is currently distributable. So, for example, if the trustee may distribute up to 5% of principal annually for the education of beneficiaries, the trustee may only decant to that extent and for that purpose.

C. Protecting the Trustee

As a practical matter, decanting is far more likely to be employed and in a far more creative and potentially beneficial manner in cases where the trustee is adequately protected from potential liability for having engaged in the decanting transaction. Therefore, decanting works best when the trustee is fully protected from liability for having undertaken the decanting transaction. Under Delaware law, adult trust beneficiaries may release a trustee from liability for engaging in a decanting transaction. 12 Del. C. § 3588. Furthermore, the releases of the trust's adult beneficiaries and presumptive remaindermen generally will bind the trust's minor and unborn beneficiaries and contingent remaindermen. 12 Del. C. § 3547. Not surprisingly, trustees tend to be far more receptive to decanting opportunities when all of the current adult and presumptive remaindermen beneficiaries are prepared to consent to the transaction in a fashion that binds the other trust beneficiaries.

D. Ascertainable Standard

Some state's decanting statutes appear to permit decanting only when the trustee is permitted to distribute trust principal in the trustee's sole discretion and not pursuant to an ascertainable standard. The Delaware decanting statute, however, permits decanting in every case where the trustee is empowered to distribute principal without regard to whether the trustee's distribution power is constrained by an ascertainable standard. Of course, if an ascertainable standard is imposed upon the trustee, the trustee must abide by that standard when decanting just as would be the case if the trustee were making an outright distribution from the trust.

E. Governing Law Considerations

The Delaware decanting statute provides that the use of the statute to decant shall be considered the exercise of a power of appointment (other than a power to appoint to the powerholder, the powerholder's creditors, the powerholder's estate, or the creditors of the powerholder's estate) and shall be subject to the provisions of Chapter 5 of Title 25 of the Delaware Code concerning the time at which the permissible period of the rule against perpetuities begins and the law which determines the permissible period of the rule against perpetuities. Chapter 5 of Title 25, together with the Delaware Chancery Court's opinion in Wilmington Trust Company v. Wilmington Trust Company (26 Del. Ch. 397, 1942), makes clear that the validity of the exercise of a limited power of appointment (and, by virtue of the cross reference in the decanting statute, the validity of a decanting transaction) is governed by Delaware law whenever the trust has its situs in Delaware at the time that the power is exercised. This result is confirmed by the express provisions of 12 Del. C. § 3528(f) which was added to the statute by a 2011 amendment. Accordingly, the trustee of a trust initially created outside

Delaware and governed initially by the law of some other jurisdiction, could, as a matter of Delaware law, decant pursuant to the Delaware decanting statute if the trust's situs were moved to Delaware. Thus, a trustee should be able to use the decanting statute whenever the trust is administered in Delaware even if some other jurisdiction's laws govern the trust's validity, construction and administration. It should be noted, however, that in most cases Delaware law would govern matters of administration for so long as the trust's situs is Delaware. See 12 Del. C. § 3332. Furthermore, Delaware's release statute (12 Del. C. § 3588) and virtual representation statute (12 Del. C. § 3547) might not be available unless Delaware law governs administration meaning that the utility of the decanting statute might be severely compromised given the understandable reluctance of trustees to decant without some assurance that the beneficiaries will not sue the trustee if the decanting turns out to produce some adverse consequence from the point of view of one or more of the beneficiaries.

IV. Possible Uses of Decanting Statute

A. Alter Administrative Provisions

Probably the most obvious and common use of decanting statutes in Delaware and elsewhere is to improve the trust's administrative provisions without altering beneficial interests in any manner. The statute can be used in Delaware, for example, to (i) add a direction or consent investment or distribution adviser to invest or participate in the investment of some or all of the trust assets or direct or participate in distribution decisions; (ii) modernize antiquated provisions; (iii) incorporate modern or more flexible investment authority; (iv) enumerate express powers useful or perhaps essential to the trustee; (v) add other advisers; (vi) add trust protectors or similar fiduciaries having special roles or powers such as the ability to oversee or remove trustees or other fiduciaries; (vii) revise provisions that otherwise might cause potential

tax problems; and (viii) revise standards of care or liability as appropriate to increase trust flexibility.

B. Clarify Ambiguous Provisions

Ambiguous provisions and other inartful provisions may be addressed by decanting to a second trust governed by a second governing instrument identical to the first governing instrument except to the extent necessary to resolve the ambiguity or other problematic provisions appearing in the first governing instrument. However, in such cases, if the resolution of an ambiguity even arguably alters beneficial interests, or could in any circumstance have the effect of altering beneficial interests, a prudent trustee will not generally engage in the decanting transaction unless the trustee is protected by appropriate releases binding all of the current and potential trust beneficiaries and the trustee, in consultation with competent advisers, is satisfied that the resolution does not raise material tax considerations as there are many situations in which altering ambiguous provisions could create adverse income, gift or generation-skipping transfer tax consequences.

C. Extend the Life of Trust

As was mentioned in III.E above, the Delaware decanting statute provides that the use of the statute to decant shall be considered the exercise of a limited power of appointment and shall be subject to the provisions of Chapter 5 of Title 25 of the Delaware Code covering the time at which the permissible period of the rule against perpetuities begins. For the reasons explained in III.E, Delaware law will govern this issue if the trust is located in Delaware at the time of the decanting and under a unique provision of Delaware law it is possible to commence a new perpetuities period by virtue of the exercise of a limited power of appointment. Consequently, and without regard to the law governing the validity of the first trust or whether

the first trust is of limited duration, a trustee may validly decant from a first trust of limited duration to a second trust of longer duration than the first including to a second trust of perpetual duration. For creditor protection purposes, state income tax avoidance and for many other reasons, the possibility of decanting to allow assets to remain in trust for longer than permitted by the first governing instrument may be extremely advantageous. However, in any case where the first trust is exempt from generation-skipping transfer tax by reason of the effective date rules or the allocation of generation-skipping transfer tax exemption to the first trust, the second trust will be subject to the generation-skipping transfer tax, for the reasons explained in V.A. below, unless (i) all of the beneficial interests in the second trust vest at the same time as the beneficial interests would have vested under the terms of the first governing instrument and (ii) the trust assets are includible in the gross estate of the beneficiaries in whom the beneficial interests vest if any of those beneficiaries die before those assets are distributed to them.

D. Create Subtrusts

Trustees frequently encounter material divergences in the needs and investment philosophies of a trust's beneficiaries. One solution that often ameliorates the tension sometimes caused by differing beneficiary needs and investment philosophies is to divide the assets of a single trust into separate trusts or separately invested trust shares for the appropriate beneficiaries or beneficiary groups. Decanting to separate trusts or to a second trust with appropriate subtrust or share language can often accomplish the desired result.

E. Avoid State Income Tax

Although the topic is beyond the scope of an outline discussing Delaware law, it appears that, pursuant to the income taxation laws of some states, trusts created by residents of the state are subject to state income taxes while identical trusts created by nonresidents of the

state are not subject to state income taxation. If so, it may be that a trust created by a decanting (in most cases the second trust to which trust assets are decanted is, at least as a matter of trust law, "created" by the trustee of the first trust) would not be subject to income taxation by a state that taxes the first trust's income because the first trust was created by a resident of the state while the second trust was not.

F. Grant Powers of Appointment

Although Delaware law does not permit a trustee to create new trust beneficiaries by means of a decanting (and a contrary rule, such as appears to exist in some states, may create grave public policy concerns not to mention angst among settlors), the statute does permit the trustee to grant a general or limited power of appointment over trust property to a beneficiary to whom the trustee otherwise could have appointed the property made subject to the power. This provision seems not to raise public policy concerns as it seems appropriate to permit the trustee to allow a beneficiary to decide who takes the trust property in cases where the trustee could alternatively have distributed the property to the beneficiary who could then have given the property to whomever the beneficiary wished. The difference between the two alternatives is, of course, that while both achieve the same economic result, the outright distribution and gift often will produce adverse gift tax consequences while decanting to a second trust and granting a limited power of appointment can, with proper planning, be done in many cases so as to avoid the federal gift tax.

V. Generation-Skipping Transfer Tax Considerations

A. Treasury Reg. § 26.2601-1(b)(4)(i)(D)

Example (2) appearing in Treasury Regulation § 26.2601-1(b)(4)(i)(E) expressly addresses the fact pattern that appears to be applicable in every case where assets held in a first

trust that is exempt from the generation-skipping transfer tax by reason of the effective date rules (that is, the first trust is a "grandfathered" trust) are decanted to a second trust. The Example posits a scenario in which assets are decanted from a grandfathered trust to another trust pursuant to a state decanting statute that was not in existence at the time the grandfathered trust became irrevocable. As no decanting statutes existed prior to the advent of the current generation-skipping transfer tax regime, it appears that all decantings from grandfathered trusts made pursuant to a state decanting statute are covered by Example (2). The Example concludes that the decanting constitutes a "modification" governed by Treasury Regulation § 26.2601-1(b)(4)(i)(D). This conclusion seems plainly correct because that regulation covers all modifications not described in paragraphs (b)(4)(i)(A), (B) or (C). Paragraph (A) in tantalizing, but apparently misleading, fashion provides that a decanting is treated as the exercise of a power (meaning the duration of the trust can be extended in certain cases) but only if the state law permitting the decanting existed before the trust became irrevocable (as is never the case given the recent vintage of the decanting statutes). As paragraphs (B) and (C) of § 26.2601-1(b)(4)(i) offer nothing of interest to decanting transactions, all statutory decantings with respect to grandfathered trusts are stuck with the straightjacket of paragraph (D). It is worth noting, however, that a trust, exempt from generation-skipping transfer tax by reason of the allocation of generation-skipping transfer tax exemption, which was created in a state that permits decanting and was created after the enactment of that state's decanting statute apparently is covered by paragraph (A) as the Internal Revenue Service as repeatedly ruled, in the private letter ruling context, that the regulatory principles concerning grandfathered trusts should apply with equal force to trusts exempt from the generation-skipping transfer tax by reason of the allocation of generation-skipping transfer tax exemption. In any case, the aforementioned "straightjacket" of

paragraph (D), apparently applicable to all grandfathered trusts, provides, in substance, that the decanting will not cause the second trust to be subject to the generation-skipping transfer tax provided that (i) the decanting could not (under any circumstance) shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in Code section 2651) than the person or persons who held the beneficial interest prior to the decanting and (ii) the decanting does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the first trust. As a result, great care must be taken in decanting assets from a grandfathered trust. However, it plainly is permissible to extend the duration of the trust so long as there is no delay in the vesting of interests.