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Strafford Publications Webinar  
November 12, 2013  
Trust Decanting:

## FLEXIBILITY AND DANGER

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# INTRODUCTION TO DECANTING

- A decanting statute permits a trustee who has the authority to invade the principal of a trust (and in some cases trust income) for the benefit of one or more trust beneficiaries to exercise that authority by transferring some or all of the assets of the trust in further trust.
- The rationale underlying decanting is that a trustee who has the discretion to make an outright distribution of trust property to or for the benefit of one or more current beneficiaries of the trust has a special power of appointment over the trust property that allows the trustee to distribute the property to another trust for the benefit of one or more beneficiaries of the trust.
- Nineteen (19) states have enacted specific decanting legislation and at least two other states have proposed statutes.

# HOW IS DECANTING USED?

- Real Examples:
  - Eliminate an income interest
  - Make a “directed trust”
  - Postpone a withdrawal or distribution right
  - Divide a pot trust
  - Eliminate a beneficiary from a class of discretionary beneficiaries
  - Grant a beneficiary a power of appointment
  - Eliminate a trustee duty to notify or report to beneficiaries
  - Migrate the administrative and/or tax situs of a trust
  - Alter administrative provisions

# OVERVIEW OF STEPS

1. Evaluate the trustee's power to decant (Possibly change situs and governing law).
2. Evaluate trustee's duties in connection with decanting.
3. Evaluate trustee risk.
4. Assess virtual representation for consent/release.
5. Assess tax implications.
6. Draft the documents.
7. Obtain beneficiary consent or release with accounting.
8. Satisfy statutory procedures like notice or court filing.
9. Set up new trust accounts, get new EIN, etc.
10. Transfer assets.

# STEP 1: EVALUATE POWER TO DECANT

1. Evaluate the trustee's power to decant
  - What state law governs the trust?
  - Does the trustee have the power to decant under the instrument?
  - Does the trustee have the power to decant under a statute that does apply or could apply?
  - What is the nature of the power to distribute principal?
  - Does the power granted by the instrument or governing law allow you to make the changes you want?
  - Must/can the trust be moved to a new jurisdiction that permits decanting?
    - How do you move the trust?
    - How do you change applicable law?

# WHAT LAW APPLIES?

- Many statutes provide that the decanting shall be viewed as an exercise of a power of appointment. Under Delaware law, the validity of the exercise of a power of appointment is governed by the laws of the jurisdiction in which the trust is administered. The Delaware decanting statute provides that the statute shall apply to any trust administered in Delaware.
- However, other states may have a different conflicts of laws approach to the applicability of a decanting statute.
- The issues of situs, governing law and place of administration can become complicated, particularly if a trust is being moved to a jurisdiction in order to utilize a decanting statute.
- If these issues are not addressed, there can be risk that the decanting was not proper, or that the trustee cannot effectively obtain releases.
  - It may be necessary to get legal counsel in one or more jurisdictions to address these multi-jurisdictional issues.

# CHANGING GOVERNING LAW

- When does the state's decanting statute apply?
- Can you change the law governing administration to effectively use releases and virtual representation under applicable law?
- How do you move the trust to a new jurisdiction and change applicable law?
  - Flexible change of situs/governing law provision
  - Traditional conflicts of laws rules
  - Delaware Supreme Court Peierls Decisions



# EVALUATING THE TRUSTEE'S POWER TO DECANT

- The trustee generally must have the power to distribute all of the principal (or in some cases income) to one or more beneficiaries (discretion or ascertainable standard).
- Are there any procedures to be satisfied when distributing principal (e.g. does the trustee make distributions with the direction or consent of another)?
- Compare the original instrument to the new instrument, identify the differences, and assess whether the proposed changes are permissible under the applicable statute.
- Does the decanting statute limit the ability to reduce the standard of liability of the trustee of the new trust?
- **Administrative Changes:** Typically, administrative provisions can be modified in almost any way that is desired.
- **Changing Beneficial Interests:** However, if the decanting alters the beneficiaries' interests, then close scrutiny is necessary to ensure that the new instrument does not run afoul of the applicable statute.
  - Generally, you cannot add beneficiaries or change or eliminate the interests of beneficiaries who are not currently proper objects of an exercise of the power to distribute principal.
  - Different statutes may also have other specific limitations (such as the inability to change the income interest under a marital trust or change the vesting of an interest under a 2503(c) trust).

# STEP 2: EVALUATE THE TRUSTEE'S FIDUCIARY DUTIES

- The decanting must be consistent with the trustee's applicable fiduciary duties for making a distribution.
- When a trustee decants, it is making a distribution of the trust assets.
- In exercising its discretion, the trustee must uphold its duties of impartiality, care and loyalty to all of the trust beneficiaries. Are the changes to be made by the decanting consistent with those duties? Does this present risk to the trustee?
- If there is a standard for making principal distributions, such as an ascertainable standard, the decanting must comply with the standard.
- Where a trustee has the power to invade the principal of a trust for a beneficiary that is subject to a standard, the trustee owes the other beneficiaries of the trust the duty of care to make some investigation to learn whether the condition precedent to the right to the principal exists and justifies the distribution.
- A corporate trustee will typically run the decision through its Trust Committee responsible for discretionary distributions.

# STEP 3: EVALUATE TRUSTEE RISK

- A trustee will generally be concerned about the potential liability for breach of fiduciary duties associated with its exercise of discretion to appoint the trust assets to the new trust, unless the reasons for the decanting are so ministerial and innocuous that it poses little or no risk to the trustee.
- The risk could be limited, or eliminated, if all of the beneficiaries consent to the decanting and release the trustee for all liability in connection with it.
- Of course, it is not always the case that all of the beneficiaries are living adults and there are often contingent remainder beneficiaries who might potentially complain in the future.
- Fortunately, many jurisdictions, like Delaware, have virtual representation statutes that can effectively bind all present and future beneficiaries of the trust if all of the adult beneficiaries release the trustee, and there is no conflict of interest between those beneficiaries and the parties represented (this is more easily accomplished when the changes caused by the decanting are administrative in nature and are not changes to beneficial interests).
- HOWEVER – What law governs the releases and virtual representation?

# TRUSTEE LIABILITY CONCERNS

## TWO LINES OF DEFENSE

- A trustee should have two lines of defense in connection with a decanting, if the trustee has the power to make principal distributions in its discretion.
- First, the trustee can get release and indemnification agreements from the beneficiaries with virtual representation binding the minors and unborns.
- Second, even if there is some issue with the release and indemnification, the trustee's actions will be judged under the abuse of discretion standard. This provides that the trustee's exercise of discretion will only be overturned if it's actions were arbitrary or capricious, not merely unreasonable.

# STANDARD OF REVIEW FOR TRUSTEE'S EXERCISE OF DISCRETION

- If the trustee has discretion to make distributions under the original instrument, then the decision to make the distribution would typically be reviewed by a court under an abuse of discretion standard.
- The trustee should process the decision through its usual procedures for making a discretionary distribution.
  - The trustee should make the decision through its discretionary distribution committee.
  - The trustee should investigate the facts and circumstances.
  - It may be advisable to get advice from legal counsel.
  - The process should be documented.

# STEP 4: ASSESS VIRTUAL REPRESENTATION

- Prepare a family tree and identify beneficiaries – adults and minors.
- Apply the virtual representation statute to the facts.
- Do the changes resulting from the decanting result in a conflict of interest between the consenting adults and the minor, unborn and unascertainable beneficiaries being represented?
- Consider every implication of the decanting.
  - Will any signors be exculpated or be given greater authority or control?
  - Do the parties have different interests in the outcome, different investment objectives, different interests in income or growth, etc.?

# STEP 5: ASSESS TAX IMPLICATIONS

- In Notice 2011-101 (the “Notice”) the IRS requested comments from practitioners regarding the income, gift, estate and GST tax issues and consequences of a decanting that changes beneficial interests of the first trust.
- The Notice identifies certain facts and circumstances as potentially having tax consequences. These include situations where:
  - A beneficiary’s right to or interest in trust property is changed;
  - Trust beneficiaries are added;
  - Beneficial interests are added, deleted, or changed;
  - Assets are transferred from a grantor trust to a non-grantor trust or vice versa;
  - Beneficiaries of the first trust are required to consent, are not required to consent or actually do consent even though consent is not required;
  - The identity of the transferor for gift and/or GST tax purposes changes; and
  - The first trust is a GST grandfathered trust or is exempt from GST tax.
- While this issue is under study, the IRS has advised that it will not issue any private letter rulings with respect to a decanting that involves a change in beneficial interests

# STEP 5: ASSESS TAX IMPLICATIONS (Cont.)

- If the changes made by the decanting do not shift beneficial interests and are purely administrative then there should be little risk of adverse tax consequences.
- Evaluate income, gift, estate and generation skipping transfer tax issues.



# TWO DECANTING SAFEHARBORS FOR GRANDFATHERED GST EXEMPT TRUSTS

- Discretionary Distribution Safe Harbor (Treas. Reg. 26.2601-1(b)(4)(i)(A)).
  - When the trust became irrevocable, either the terms of the trust instrument or local law authorized distributions in further trust without the consent or approval of any beneficiary or court; and
  - The resulting trust does not extend the time for vesting of any interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, beyond the longer of (a) lives in being plus 21 years, or (b) 90 years.
- Trust Modification Safe Harbor (Treas. Reg. 26.2601-1(b)(4)(i)(D)).
  - the distribution does not cause a beneficial interest to be shifted to a beneficiary in a lower generation, and
  - the governing instrument of the resulting trust does not extend the time for the vesting of any beneficial interest beyond the period provided for in the original trust instrument.

# STEP 6: DRAFT THE DOCUMENTS

- **Simple Decanting Instrument:** Depending upon the number of changes, you might simply draft a simple decanting instrument that provides that the new trust shall be held in accordance with all of the terms and conditions of the original trust subject to some enumerated changes and additions.
- **New Trust Agreement:** Alternatively, you might draft an entirely new trust agreement with a separate decanting instrument that memorializes the trustee's exercise of its power to decant the assets of the original trust to the new trust.
  - The new trust could be a declaration of trust, or have the trustee of the original trust as the grantor, or it could have some other person as the grantor.
  - Make the dispositive provisions of the new trust instrument closely resemble the original instrument to avoid confusion about what was changed.
- **Trustee Release, indemnification and approval of account.**

# STEP 7: OBTAIN CONSENTS AND RELEASES WITH ACCOUNTS

## DECANTING AS A TERMINATION OF THE OLD TRUST

- When a trust is decanted, the assets of the first trust flow over into the second trust, and the first trust is terminated. Not only will the trustee typically seek releases in connection with its exercise of discretion to decant, but it will likely seek releases and an accounting, and any other typical procedure that a trustee in its particular jurisdiction will seek when a trust is terminated and its service as trustee ends.

## DECANTING AS A REMOVAL OF THE TRUSTEE

- Since the assets have been transferred to a new trust, which may or may not have the same trustee as the original trust, a decanting can also be viewed from the trustee's perspective as a removal of the trustee of the first trust and an appointment of a successor trustee. Consequently, it is advisable to include an indemnification provision in the new, second trust instrument that runs to the trustee of the original trust, even if the individual or corporate identity of the trustee is the same for both trusts (such individual or entity will still be serving in two different capacities).
- Thus, the outgoing trustee knows that if claims, taxes, fees, liabilities, etc. from the original trust arise in the future, which would have been properly payable from the trust, the trustee of the original, now defunct trust can still have some recourse against the new trust to be reimbursed.

## STEP 7: OBTAIN CONSENTS AND RELEASES (cont.)

- Attachments to the Release should include:
  - Full accounting
  - Original trust instrument
  - New Trust instrument
  - Decanting instrument
  - Description of changes made by the decanting

# STEP 8: SATISFY REQUIRED PROCEDURES

- Some statutes may permit or require the trustee to provide notice to beneficiaries or file a notice with the court.
- Generally, a decanting requires a written instrument, signed by the trustee and notarized.

# STEP 9: SET UP NEW ACCOUNTS

- The decanting results in a newly-created trust. The trustee of the new trust will typically go through the procedure to set up a new trust account.
- The account set-up process may take some time and may involve compliance with regulatory requirements for traditional trust account set-up.
- The new trust may or may not be treated as a new, separate taxpayer with a new Tax ID Number.

# STEP 10: TRANSFER ASSETS

- As a part of the decanting, the assets of the original trust will be distributed to a new trust.
- This may require:
  - Retitling of assets and accounts;
  - Transfers of limited liability company interests through assignment and assumption agreements;
  - Retitling stock and stock certificates; and
  - Retitling real estate.
- These steps must be completed properly to abide by the technical requirements of the transaction.

# PLANNING AHEAD FOR DECANTING

- By far, the biggest hurdle in accomplishing a decanting is the trustee's reluctance to take on the risk associated with the exercise of discretion. There may be potential transfer tax issues associated with getting beneficiary consents or releases.
- When drafting new trust agreements, it is advisable to draft:
  - express decanting provisions to facilitate broad decanting powers; and
  - enabling provisions in the agreements which limit a trustee's liability and provides indemnification in connection with a decanting.
- This kind of advanced planning might provide the flexibility and protection for a trustee to enable the trustee to perform a decanting in the future, if it is desired by the beneficiaries, without the delay and expense of releases, accountings, indemnifications, etc.