

TRUST DECANTING

Presented to:

San Antonio Estate Planners Council

Presented by:

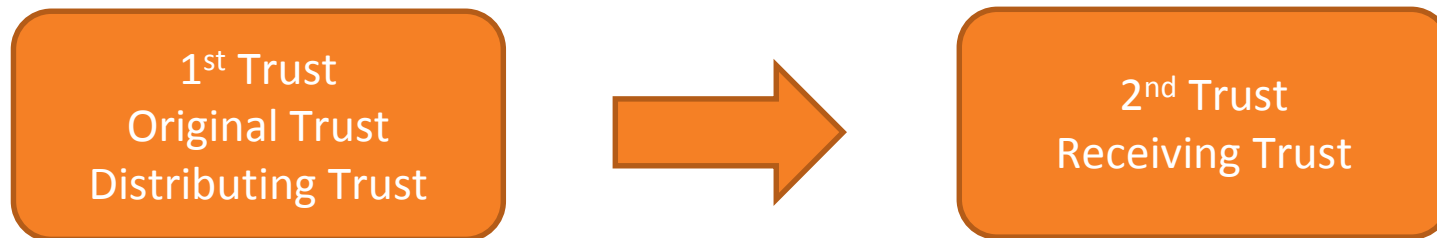
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TRUST DECANTING

Change the terms of an irrevocable trust

- Exercise of trustee's discretionary authority to distribute trust assets
 - Like a Limited Power of Appointment (see 12 Del Stat. §3528)
 - Fiduciary Duty
- Action by Trustee - Does not require court involvement or beneficiary consent



DECANTING



Graphic by Brian DeYoung from "When to 'Decant' a Trust" by Liz Moyer, Wall Street Journal 1/3/2014

OTHER WAYS TO CHANGE AN IRREVOCABLE TRUST

- Merger
 - No material change in beneficial interest or purpose of trust
 - Notice to beneficiaries
 - Does not require court approval in most states
 - Action by Trustee
- Non-Judicial Settlement Agreement
 - Generally for administrative changes
 - Does not violate a material purpose of the trust
 - Requires consent of interested persons
 - Does not require Trustee involvement
- Reformation (Amendment, Modification, Equitable Deviation)
 - Does not require Trustee involvement
 - Non-judicial (Consent Modification)
 - Best if few beneficiaries and settlor is alive and all consent
 - Judicial
 - Time consuming and expensive but may be best in some circumstances

WHEN TO CONSIDER DECANTING

- Administer trust in a more trust friendly jurisdiction
 - Direction Trust Statute – modernize administrative or investment provisions
 - Self-Settled Spendthrift Trust (Asset Protection Trust)
 - Unitrust Conversion
- Escape state income tax
- Add or change beneficiaries
- Grant a beneficiary a Power of Appointment
- Accelerate, postpone or change distribution provisions
- Change trust from a grantor trust to a non-grantor trust or vice versa
- Divide or combine trusts
- Change trust to a Supplemental Needs Trust
- Extend the length of the trust term or terminate a trust
- Correct a drafting error

SOURCES OF DECANTING POWER

Common Law

- Florida: *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782 (1940)
 - First case recognizing trustee authority to decant
- Massachusetts: *Morse v. Kraft*, 466 Mass. 92 (2013)
 - Most recent case
- Also New Jersey (*Wiedenmayer v. Johnson*) and Iowa (*Estate of Spencer*)
- Presumption in Texas – new decanting statute states that it is a codification of Texas common law

Restatements

- Restat 2d of Prop: Donative Transfers, § 11.1 (1986)
 - Trustee's discretionary distribution powers are deemed a special power of appointment
- Restat 3d of Trusts § 50 (2003)
 - Distinguishes a fiduciary distributive power from a discretionary power of appointment because the exercise of the fiduciary distributive power is subject to the trustee's fiduciary obligations whereas a POA can be exercised arbitrarily

SOURCES OF DECANTING POWER

Statutes

- New York was the first in 1992
- Now 21 states have adopted decanting statutes
 - M. Patricia Culler list on ACTEC website (latest 11/15/2013)
 - Susan Bart summaries of each state’s statutes on Sidley Austin’s website

Alaska	Arizona	Delaware
Florida	Illinois	Indiana
Kentucky	Michigan	Missouri
Nevada	New Hampshire	New York
North Carolina	Ohio	Rhode Island
South Carolina	South Dakota	Tennessee
Texas	Virginia	Wyoming

STATE DECANTING STATUTES CURRENTLY VARY

Common Differences

- Explicit Choice-of-Law Rule
- Notice to Beneficiaries Required
- Explicit Standard of Review
- Required Invasion Authority
 - Full Discretion Standard – e.g. Florida – Trustee must have
 - Ascertainable Standard – e.g. Delaware and Texas may decant
- Expressly Authorizes Adding a Power of Appointment
- May Change Distribution Standard
- Extend Past Original Perpetuities Period

ANTICIPATED CHANGES TO DECANTING STATUTES

National Conference of commissioners on Uniform State Laws

- Uniform Decanting Distributions Drafting Committee – met on 12/7/2013

IRS

- Will not issue rulings or PLRs regarding decanting until a formal publication
- Notice 2011-101, 2011-52 I.R.B. 932 requested comments
- 2011-2012 Guidance Plan included as item 13 “Notice on decanting of trusts”
- Decanting omitted from both the 2012-2013 and 2013-2014 Priority Guidance Plans (still nothing on decanting in January 2014 update)
- Can expect to see something on decanting in the Guidance this year

TEXAS'S DECANTING STATUTE

Tex. Prop. Code § 112.071 – 112.087

- 83rd Leg., ch. 699 (H.B. 2913), § 3, effective September 1, 2013
- Trustee may decant with either full or limited discretion to distribute, but there are different provisions for each type
- There are several tax savings provisions, including those for marital and charitable deductions
- The decanting may not eliminate a beneficiary's mandatory distribution rights
- Trustee must send written notice to all current beneficiaries and presumptive remainder beneficiaries of the first trust prior to decanting (30 days)
- Trustee has no affirmative duty to decant
- May not
 - Materially impair the rights of any beneficiary of the trust
 - Materially limit a trustee's fiduciary duty
 - Decrease or indemnify trustee liability

DELAWARE'S DECANTING STATUTE

12 Del. C. § 3528

- Second state to pass decanting statute after New York
- Has undergone many amendments since initial enactment in 2003
- Standard of care/liability is the same as making outright distributions
 - Courts generally defer to trustee's judgment absent evidence of arbitrary or bad faith conduct
- Trustee has no duty to notify beneficiaries
- Delaware's decanting statute may be used by any trust that is "administered" in Delaware notwithstanding that another jurisdiction's laws govern the validity, construction and the administration of the trust

COMPLICATIONS OF DECANTING

- Trustees are uncomfortable with liability exposure
- Tricky tax issues
- Can be a long, complicated and expensive process
- Still some uncertainty regarding this technique
 - Is the 1st trust terminated or is the 2nd trust a continuation of the 1st trust?

TRUSTEE EXPOSURE TO LIABILITY

- Generally, no affirmative duty to decant
- Trustees have fiduciary duties to beneficiaries of impartiality and loyalty
- Must follow the language in the document and state law
 - Consult state decanting statutes to determine specifically outlined fiduciary duties when exercising decanting powers
- What is the standard of judging the trustee's discretion to decant in the state?
- Considerations regarding beneficiary notice
 - To notify or not to notify the beneficiaries?
 - Obtain settlor and beneficiary consent or use a Release and Indemnification Agreement?
 - Tax Consequences
 - Expose otherwise protected assets to creditor claims
 - Use of a Receipt and Refunding Agreement?
- Court involvement considerations

TAX ISSUES

Income Tax

- Will Subchapter J rules apply? Will Distributable Net Income (DNI) be carried out to the new trust or will the 2nd Trust be considered a continuation of the 1st Trust?



- Capital Loss Carryovers and Credits
 - If all of the assets of the 1st trust are distributed, the 2nd trust should succeed to the 1st trust's tax attributes
- Gain recognition if trust holds appreciated assets?
 - By Beneficiaries – should not since decanting happens by trustee action
 - By 1st Trust – should not but 2nd trust should get a transferred basis
- Caution – consider state and local tax consequences when moving trusts between jurisdictions

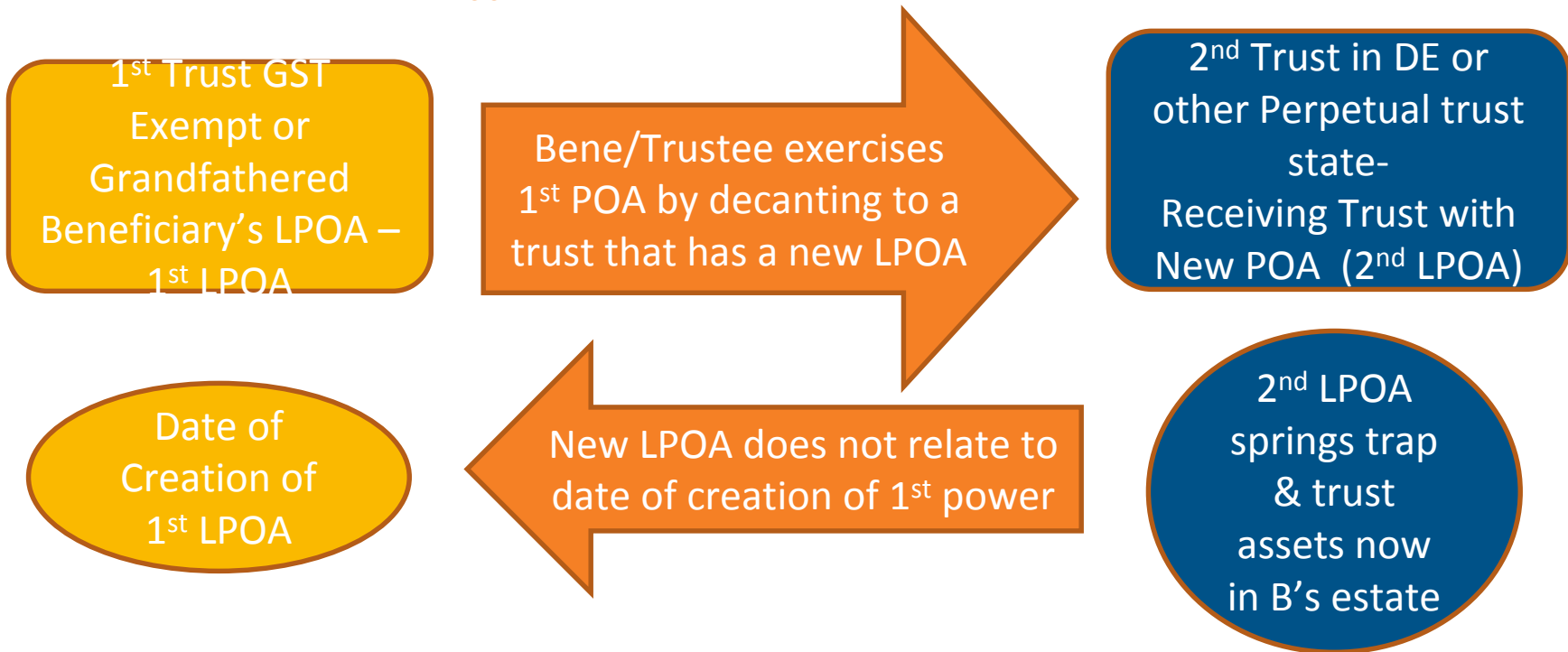
TAX ISSUES

Gift Tax

- There must be an act of transfer – Trustee action in decanting
 - Trustee has no donative intent
 - What if Trustee is also a Beneficiary and his/her interest in the trust is reduced?
- What if Beneficiary Consents to Decanting?
 - Texas does not require beneficiary consent to a decanting

TAX ISSUES

Delaware Tax Trap - §§ 2041(a)(3) & 2514(d)



- Exercise of LPOA under 1st trust treated as a gift
- Can be avoided if clause in the second trust provides that vesting cannot be extended through the exercise of a SPOA beyond a period ascertainable with regard to the date of the creation of the first trust

TAX ISSUES

Estate Tax

- Beware of granting a beneficiary a general power of appointment in the 2nd trust
 - Could opt for a LPOA instead
- If insurance is part of the assets in the trust beware of giving the grantor or beneficiaries “incidents of ownership”
- Don’t have beneficiary or settlor consent to decanting if it is not necessary under the trust language or state decanting statute
 - Don’t want beneficiary to be seen as making a gift of an interest
 - Don’t want settlor to be deemed to have an implied right to control property

TAX ISSUES

Generation Skipping Transfer Tax

- If first trust not GST exempt, distribution could cause GST tax to be triggered
- Grandfathered GST Exempt Trust – if asset transfer to irrevocable trust prior to September 25, 1985 & GST Exempt Trusts because of exemption allocation
- Decanting could cause the loss of exempt status
- Safe Harbors under Treasury Regulation § 26.2601(b)(4)
 - Discretionary Distribution Safe Harbor
 - Decanting was done pursuant to terms of trust instrument or common law AND
 - Trustee may exercise decanting power without beneficiary consent or court approval AND
 - Perpetuities period not extended beyond the federal RAP
 - Trust Modification Safe Harbor “Catch-all safe harbor”
 - Cannot shift beneficial interest to a beneficiary in a lower generation AND
 - Cannot extend perpetuities beyond what is provided in 1st trust

MECHANICS OF DECANTING

Preliminary Matters

- Look to terms of trust – Decanting provision? Prohibition?
- State law – which state’s law governs administration?
 - Choice of Law? Silent? Any state court currently involved (primary jurisdiction)?
- Change trust situs by appointing Trustee in jurisdiction with decanting statute
 - Conflict of Laws? (*Peirels*)
 - Delaware’s decanting statute available to any trust administered in Delaware
 - 1st trust could be decanted to 2nd trust with Delaware law governing administration
- Address vested withdrawal powers – leave sufficient assets in 1st Trust
- Any fraudulent conveyance concerns?
- Address tax consequences
- Address fiduciary concerns
 - Will trustee want a Release and Indemnification? Receipt and Refunding?
 - Standard of care
 - Notice to Beneficiaries required or recommended?
 - Will Trustee seek court approval?

MECHANICS OF DECANTING

Documents

- Notice to beneficiaries – current and presumptive remainder
 - 30 days under Texas statute
- A newly drafted trust or an existing trust
- Trustee Resolution to Decant
 - Terms of Trustee’s exercise of power and terms of original trust
 - Background information
 - Information required by state law and the governing instrument
 - Resolution designating and appointing assets to 2nd trust
 - Generally must be a writing that is signed and acknowledged by the trustee and kept with the records of the original trust
- Transfer documents to re-title assets

DELAWARE - PEIERLS

Migration of Trusts – conflicts of laws

- Petitions filed in Delaware Court of Chancery by non-Delaware individuals seeking to move a series of trusts to Delaware and make them directed trusts
- Determine which court has primary jurisdiction
- Delaware law will govern administration of trusts moved to Delaware
 - When trust provision allows for appointment of successor trustee
 - Without geographic limitation
 - Even if choice of law is another state
 - As long as not contrary to Settlor's intent that choice of law shall *always* govern
- Advisory Opinion – court will not rule on matters specifically allowed in trust
- No longer allowed to file petition seeking conditional appointment of Trustee
 - So new Trustee would be directed from inception of appointment
 - Obstacle in determining that trusts were presently administered in Delaware
- If Decanting to Delaware – make sure Delaware Trustee is administering trust
 - What is sufficient for “administration”?

EXAMPLE ONE

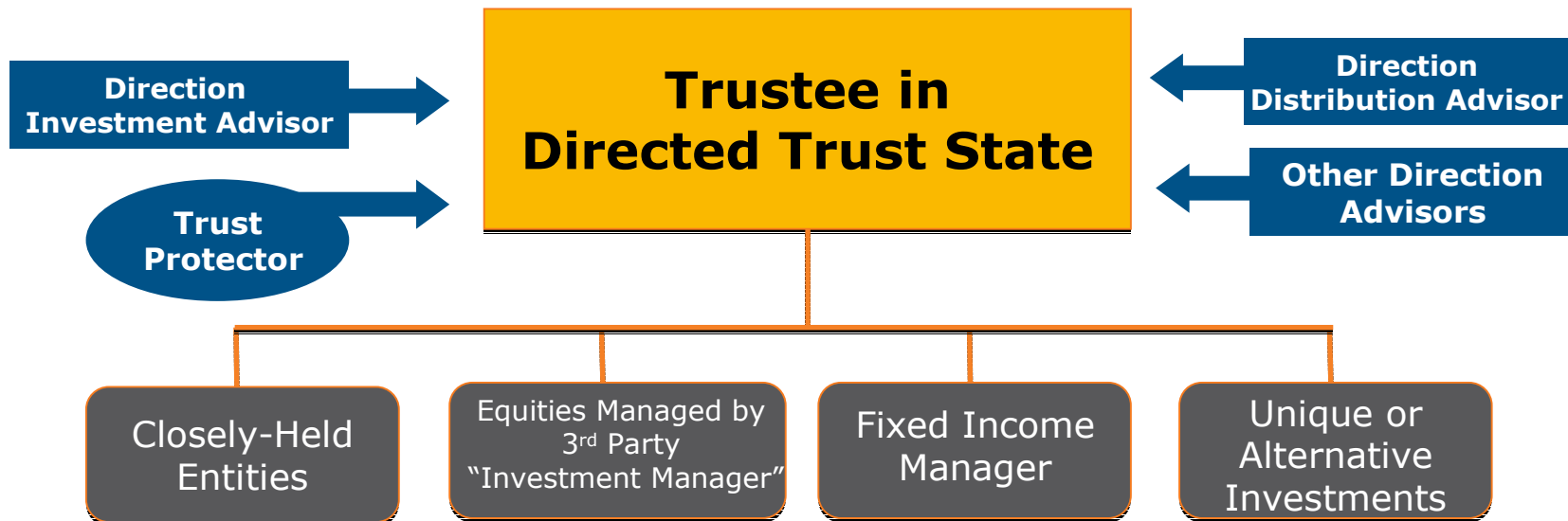
To Clarify Original Intent and Reduce Trustee Liability

- Dynasty trust with a large position in a single stock
- Trustee constantly pressuring family to sell and diversify
- Family wanted to keep the concentrated position & had new concerns about grandchildren feeling entitled
- Family decanted the trust
 - Added a no duty to diversify provision limiting the trustee's liability
 - Changed distribution age for grandchildren to 35 and distribution standard to discretionary

EXAMPLE TWO

To Divide Trustee Responsibilities & Liabilities – Directed Trust

- Texas follows the UTC §808(b); Tex. Prop. Code Ann. §114.003(b)
 - Trustee has oversight responsibility
- Delaware has a more protective statute, 12 Del. C. §3313 – bifurcation of duties
 - Willful misconduct standard applied to following a direction
 - Lower fees for directed trusts



EXAMPLE THREE

To Postpone Distributions to Beneficiaries

- 1st Trust established in 1995 for settlor's 5 year old child
 - Held \$100,000 worth of shares in Settlor's private company
 - Trust to terminate when child turned 25 and lump sum paid out
- Company went public and value of the assets is now worth \$200 million
- Child is now 24 and concerned about protecting those assets and paying state income tax on large distribution of highly appreciated assets
- Decanting can accomplish many things
 - Extend the period of time the trust can hold assets for the beneficiary
 - Add or clarify spendthrift provisions to bolster asset protection aspects
 - Allow beneficiary to move to a non-income tax state like Florida before receiving large distributions
- Will have to address GST issues

EXAMPLE FOUR

To Avoid State Fiduciary Income Tax for Non-Grantor Trusts

- DING (Delaware Incomplete-Gift, Non-Grantor) Trust
- Strategy designed to eliminate state income taxes on the settlor's investment income by having the settlor transfer the investments to a trust domiciled in a non-tax state
 - Must be a Non-Grantor Trust (Income Tax), and
 - Must be an Incomplete Gift to the Trust (Gift and Estate Tax)
 - See PLR 201310002 – Ruling specifically on DING planning
- To plan for future liquidity event – sale of a business
- Make sure you can cut ties with all other taxing jurisdictions
 - Resident Trust

DING PLANNING



	New York City	Delaware
Assumed Taxable Capital Gain	\$ 10,000,000	\$ 10,000,000
Federal Tax	\$ 2,380,000	\$ 2,380,000
New York State Tax	\$ 897,000	0
New York City Tax	\$ 387,600	0
Total Tax	\$ 3,664,600	\$ 2,380,000
Delaware Tax Savings Potential		\$ 1,284,600

* Example is based upon a taxable capital gain of \$10 million with a federal tax of 20% plus Medicare tax of 3.8%, New York State and New York City rates are assumed to be 8.97% and 3.876% respectively.

TAX ISSUES

State Income Tax

- May nongrantor trust that is taxed in one state be moved to avoid that state's income tax?
 - Fiduciary Income: Rates in excess of 12% on accumulated income and capital gains on intangible assets
 - Texas does not tax trusts
- States tax nongrantor trusts based on various criteria
 - Trust created by will of resident testator (Continuing Jurisdiction)
 - Resident grantor of inter vivos trust
 - Trust administered in state
 - Resident fiduciary
 - Resident beneficiary
 - Location of trust property
 - State Sourced Income

PENNSYLVANIA - MCNEIL

PA Court Held Taxation of Delaware Trust Unconstitutional

- PA settlor and PA discretionary beneficiaries
- No PA income, interests or assets
- Administration of trust in Delaware with a Delaware trustee
- Settlor chose Delaware law to govern

- PA personal income tax based on residence of settlor
- Court determined that trust was taxpayer
- Tax violated Commerce Clause – no nexus
- PA resident beneficiaries pay tax on distributions but income not distributed could be accumulated in trust free of tax

EXAMPLE FIVE

Add or Change Beneficiaries

- Decanting statutes do not allow for a beneficiary who was not a beneficiary in the 1st trust to be added to the 2nd trust
- Decanting does allow for a beneficiary of the 1st trust to be granted a general or limited power of appointment in the 2nd trust
 - Look for limitations in the 1st trust like an ascertainable standard
- The beneficiary with this new POA can then add a new beneficiary to the 2nd trust that was not a beneficiary of the 1st trust
- Scenario:
 - Current income beneficiary is son of settlor. Remainder beneficiaries are children of son from his 1st marriage
 - Son wants to decant trust to new trust that gives him a new power of appointment
 - Son will use new POA to appoint an income interest to current wife who is not mother of remainder beneficiaries
 - Son first moves situs of trust to Delaware with consent of remainder beneficiaries
 - Son then decants trust under Delaware law without notice or consent of remainder beneficiaries

SOMETHING TO THINK ABOUT

If donors believe courts may not facilitate their intent, donors may be less happy, accumulate less property, and alter gifts during life.

Moreover, because the law often affects donor behavior, ignoring donative intent to benefit particular donees may harm not only the donors but also donees as a class.

Thus, the living may themselves benefit if the law allows a certain degree of "dead hand" control.

*Daniel B. Kelly, Restricting Testamentary Freedom
– Ex Ante Versus Ex Post Justification,
Fordham Law Review,
Volume 82, 1125-1185 (2013).*