

#31: Trust Decanting

Many irrevocable trusts could be amended to better accomplish the objectives of the grantor and increase the benefit to beneficiaries. The simplest and least expensive way to do so is by decanting the old trust into a new one. Instead of exercising its power to make distributions to, or for the benefit of beneficiaries, the trustee distributes assets to a new trust with different terms.

Legal Authority for Decanting

It is unclear under the common law of most states whether a trustee's power to distribute property to a beneficiary includes the power to transfer property to a trust for the beneficiary's benefit. Recently, however, many states have enacted statutes expressly authorizing trust decanting. The following states have adopted the Uniform Trust Decanting Act—Alabama, Colorado, Illinois, Maine, Massachusetts, Montana, Nebraska, New Mexico, North Carolina, Virginia, Washington and West Virginia. These states have enacted other decanting statutes—Alaska, Arizona, California, Delaware, Florida, Georgia, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Missouri, Nevada, New Hampshire, New York, North Dakota, Ohio, Rhode Island, South Carolina Tennessee, Texas, Wisconsin and Wyoming.¹⁴¹ The statutes vary considerably with respect to whether:

- (1) A trust with an ascertainable standard can be decanted;
- (2) Notice must be given to beneficiaries;
- (3) A trust with an ascertainable standard can be decanted into a discretionary trust;
- (4) A mandatory income interest can be removed; and
- (5) A power of appointment can be granted to a beneficiary of the second trust in favor of a person or entity that is not a beneficiary.

Some statutes, like those in South Dakota and Nevada confer very broad decanting powers while others, like those in Florida and Indiana, allow decanting only if the trustee has unrestricted discretion to make distributions of principal to beneficiaries. Almost all of the statutes include specific limitations on the use of decanting. For example, many of the statutes prohibit decanting if it would cause a trust to lose its status as an eligible S corporation shareholder or eliminating a vested beneficiary's right to income.¹⁴²

Reasons to Decant

Trust decanting can be used to address a variety of trust issues. Some of the most popular reasons for decanting a trust are discussed below. Before utilizing any of the strategies, advisors should make sure the decanting is allowed under the applicable state decanting statute and consider any tax issues that might be raised. Potential tax issues are noted later in this topic. Although the subject is beyond the scope of this topic, the fiduciary responsibilities of the trustees must also be considered.

Extending the Term of the Trust

¹⁴¹ Massachusetts and the District of Columbia have bill pending.

¹⁴² For a ranking of state decanting statutes in order of favorability for trustees and beneficiaries see Oshins, Steve, 1st Annual Trust Decanting State Rankings Chart. This chart can be obtained from Mr. Steve Oshins at soshins@oshins.com. It is also included at the end of this topic as an exhibit.

Many trusts are structured to terminate and pay all trust assets to a beneficiary when the beneficiary reaches a certain age or to pay assets to beneficiaries at staggered ages (e.g., 1/3 at age 25, 1/3 at age 35 and 1/3 at age 45). This can open up the trust to unnecessary estate tax, creditors and divorcing spouses. It might also have negative effects on the beneficiary's career motivation and lifestyle, particularly if trust investments have been highly successful. If the beneficiaries have not yet reached the requisite age or ages, the trustee should consider decanting the trust into a trust that delays distributions of principal. If estate tax is a concern, the trustee might consider a transfer to a dynasty trust.¹⁴³

Changing Trust Situs

Some states have much more favorable laws for trusts than others. For example, seven states don't tax trust income at all, while others have top trust income tax rates as high as 13.3%.¹⁴⁴ State laws also vary widely with respect to creditor protection and the maximum length for a trust. If the trust is located in a state with a decanting statute it may be possible to transfer assets into a new trust in a better trust jurisdiction.¹⁴⁵ It may be possible not only to save substantial amounts of state income tax, but also to lengthen the term of a dynasty trust, to move a trust to a state allowing domestic asset protection trusts (DAPTs), or to move an existing DAPT to another DAPT state offering greater creditor protection. Note that state income tax-saving trusts and DAPTs involve complex tax issues. See the Nevada Incomplete Gift Non-Grantor (NING) Trust topic and the DAPT topic in this series.

Correcting Drafting Errors or Clarifying Ambiguities

Many trusts have drafting errors or ambiguous terms that need to be fixed. While many newer trusts give a trust protector or independent trustee the power to make necessary changes, older trusts generally do not. Instead of an expensive court reformation, the trustee should consider decanting the trust into a new trust.

Combining Trusts

Clients often set up multiple trusts for their heirs that have very similar provisions. To increase administrative efficiency and save costs, trustees should consider decanting all but one trust into a single trust or decanting all the original trusts into a new one.

Splitting Trusts

Many trusts are drafted so that the entire family benefits from a single pot trust that sprinkles income. This might be a good arrangement for some families, but more often than not it creates problems because different beneficiaries have different financial needs, investment philosophies or opinions of the trustee. Subject to limitations in the applicable state statute, it may be possible to decant a

¹⁴³ Dynasty Trusts are covered in another topic in this series.

¹⁴⁴ The 13.3% rate is in California. Other high top rates include Oregon 9.9%, New York 8.82%, Iowa 8.98%, Maine 7.95%, Minnesota 7.85% and Wisconsin 7.85%.

¹⁴⁵ Transferring the trust to a more favorable jurisdiction may also be possible if the trust is located in a state that does not have a decanting statute if the trust includes a change of situs provision.

large pot trust into separate trusts for each beneficiary or for different branches of a family. A trust may also have an inclusion ratio between zero and one and the trustee may want to divide it into an exempt and a non-exempt trust for generation-skipping transfer tax purposes.

Stretching Out IRA Distributions

IRAs are often payable to a trust and may have contingent beneficiaries who are far older than the primary beneficiaries. Assuming that all beneficiaries of the trust are individuals, the designated beneficiary of the trust is the oldest individual. Thus, it might be possible to substantially increase the time period over which required minimum distributions (RMDs) must be paid by decanting to a new trust that eliminates the older contingent beneficiaries.

Adding Trustee Powers

A trustee generally has only the powers listed in the governing instrument plus any default powers included in the applicable state statute. In older trusts, these powers are often quite limited. For example, they may not provide for a succession of trustees or include a provision allowing the trustee to waive the duty to diversify or to apply the state's prudent investor statute. Older trusts might also set trustee compensation too high or too low, based on a percentage of trust accounting income or the value of the trust principal. Finally, older trusts may provide no mechanism for removing a trustee or allowing a trustee to resign without going to court. In a jurisdiction with a decanting statute, these and other trustee powers can be added or changed.

Qualifying a Trust to Own S Corporation Stock

Only certain trusts are qualified S corporation shareholders. These include grantor trusts, IRC § 678 trusts, qualified subchapter S trusts (QSSTs), electing small business trusts (ESBTs), certain testamentary trusts and voting trusts.¹⁴⁶ Many trusts have been drafted without considering the possibility that the trust might hold S corporation stock at some time in the future. If the trust agreement doesn't give a trust protector or an independent trustee the power to add provisions qualifying the trust as an S corporation shareholder, the trust could be decanted to add the required provisions.

Changing a Support Trust into a Discretionary Trust

Many trusts are drafted to give the trustee the power to make distributions to beneficiaries under a health, education, maintenance and support (HEMS) standard. Under the laws of some states the assets of these support trusts can be reached by certain classes of creditors, such as divorcing spouses. A discretionary trust, on the other hand, gives the trustee absolute discretion over distributions and thus generally protects the assets from all classes of creditors. Thus, decanting a support trust into a discretionary trust can be a valuable strategy.

Modifying Powers of Appointment

¹⁴⁶ IRC § 1361(c)(2).

When the estate tax unified credit amount was much lower and the estate tax rate was higher, trusts were generally drafted to avoid having trust assets included in the grantor's estate for estate tax purposes. Although assets not included in the estate did not receive a basis step-up at death, this disadvantage was outweighed by avoiding the estate tax, which had much higher rates. With recent increases in the unified credit (now referred to as the applicable exclusion amount), decreases in the estate tax rate and increases in the income tax rate, it may be more advantageous to have trust assets included in the grantor's gross estate. Decanting can be used to give a beneficiary a general power of appointment over assets, causing the assets to be included in the power-holder's estate and creating a basis step-up in the assets for heirs.

Adding Flexibility

Decanting can be used to increase the ability of a trust to meet changing circumstances by adding trust protectors, investment direction advisors, distribution advisors, or special asset advisors.

Spendthrift Clause

A spendthrift clause is a trust provision that prevents creditors from reaching a beneficiary's interest in a trust until the beneficiary receives distributions. Decanting can be used to add a spendthrift provision to a new trust to protect a beneficiary's assets from creditors or divorcing spouses. It can also be used to remove a spendthrift clause.

Creating a Grantor or Non-Grantor Trust

It may be possible to use decanting to convert a grantor trust to a non-grantor trust or a non-grantor trust to a grantor trust. The new trust might also be given a mechanism for toggling grantor status on and off.¹⁴⁷

Other Reasons

Other possible reasons for decanting a trust include:

- (1) Creating a special needs trust;
- (2) Separating high risk assets;
- (3) Qualifying a trust as a QDOT or IRA conduit trust;
- (4) Reducing distribution rights to qualify for Medicaid; and
- (5) Eliminating an insured as a trustee to avoid estate inclusion of a life insurance policy under IRC § 2042.

Tax Issues

Trust decanting is a developing wealth management strategy with uncertain tax consequences under current law. It raises numerous income, gift, estate and generation-skipping transfer tax issues. The IRS is studying the tax implications of decanting and considering approaches to addressing the

¹⁴⁷ See, for example, the Illinois decanting statute at 760 Ill. Comp. Stat 5/16.4.

relevant tax issues in published guidance. While these issues are under study, the IRS will not issue PLRs with respect to a decanting that results in a change in the beneficial interests of a trust (Rev. Proc. 2011-3).¹⁴⁸

In Notice 2011-101, the IRS asked for comments on the following income tax, gift and estate tax and generation skipping transfer (GST) tax issues.

Income Tax Questions

1. Whether a decanting power makes a trust a grantor trust under IRC §§ 671-679.
2. Whether the distribution from one trust to another requires gain recognition by the transferring trust under IRC § 1001.
3. Whether the distribution from one trust to another requires gain recognition for any trust beneficiary under IRC § 1001.
4. Whether the transferee trust takes all the tax attributes of the first trust.
5. Whether transferring property from one trust to another by decanting is a distribution requiring computation of DNI.

Gift and Estate Tax Questions

1. Whether a beneficiary whose interests in a trust that are reduced by the decanting has made a taxable gift.
2. Whether a beneficiary whose interests in a trust that are reduced by decanting has made an IRC § 2036 or 2038 transfer.
3. Whether a beneficiary who consents to a decanting or acquiesces in a decanting has made a taxable gift.
4. Whether a decanting power in a QTIP trust will cause the trust to lose its charitable deduction.

GST Questions

1. Whether a GST grandfathered trust that receives decanted property loses its grandfathered trust status.
2. Whether decanted property has the same GST inclusion ratio in the trust receiving the property that it had in the original trust.
3. Whether a non-exempt trust can be decanted to allow allocation of GST exemption to only a portion of the original trust.

Whether decanting assets held in the original trust that is exempt from GST tax will cause the new trust to lose exempt status is squarely addressed by Reg. § 26.2601-1(b)(4)(i)(E), Example 2. This example provides that the decanting will not taint the GST-exempt status of a grandfathered trust provided that both:

¹⁴⁸ Note that the IRS Priority Guidance Plan for 2012-2013 did not include decanting, raising questions about when decanting guidance might be available.

- 1) The decanting could not (under any circumstance) shift a beneficial interest in the trust to a beneficiary who occupies a lower generation than the persons who held the beneficial interest prior to the decanting; and
- 2) The decanting does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust.

Thus, with careful planning, it is possible to extend the duration of the trust without subjecting the new trust to GST tax. These principles governing grandfathered trusts should apply equally to trusts exempt from the GST tax by reason of the allocation of GST exemption.¹⁴⁹

Is Decanting Advisable Given the Current Tax Uncertainty?

Whether planners should go ahead with decanting may depend on the type of decanting they wish to do. Commentators have suggested that if the decanting changes only administrative provisions, there is little risk even though it is not possible to get a PLR on the tax consequences. If the decanting changes distributions or lengthens the term of the trust, however, a number of unfavorable tax consequences are possible and practitioners should proceed with caution.

Disclosures

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¹⁴⁹ See Ltr. Ruls. 200822008, 200743028, and 200714016.

8th Annual Trust Decanting State Rankings Chart – Page 1 of 2

Rank	State	Has Decanting Statute? (50% weight)	Can Decant Trust with Ascertain. Standard? (7.5% weight)	Notice to Beneficiaries Required? (7.5% weight)	Can Decant Trust with Ascertainable Standard into Discretionary Trust? (7.5% weight)	Can Remove Mandatory Income Interest? (5% weight)	Allow Power of Appointment in Second Trust to Non-Bene? (2.5% weight)	Can Accelerate Remainder Bene's Interest? (5% weight)	Dynasty Trust State Ranking (7.5% weight)	Domestic Asset Protection Trust State Ranking (2.5% weight)	Total Score
1	SD	§55-2-15	Yes	No	Yes	Yes	Yes	Yes	Ranked #1	Ranked #2	99.5
2	NV	§163.556	Yes	No	Yes	Yes	Yes	Yes	Ranked #2	Ranked #1	99
3	DE	12, §3528	Yes	No	No	Yes	Yes	Yes	Ranked #7 (tie)	Ranked #6 (tie)	88.5
4	TN	§35-15-815(b)(2)	Yes	No	Yes	No	Yes	Silent	Ranked #3	Ranked #6 (tie)	87.5
5	NH	§561-B:4-418	Yes	No, except charitable trusts	Yes	No	Yes	Silent	Ranked #10	Ranked #11	83
6 (tie)	IA	§633A.4215	Yes	No	No	Yes	Yes	Yes	Unranked	Not allowed	77.5
6 (tie)	OH	§5808.18	Yes	Yes	No	Yes	Yes	No	Ranked #7 (tie)	Ranked #3	77.5
8	MO	§456.4-410	Yes	Yes, only to beneficiaries of second trust	No	Yes	Silent	Yes	Ranked #9	Ranked #4	77
9 (tie)	AK	§13.36.157-159, §13.36.215	Yes	Yes	No	No	Yes	No	Ranked #4	Ranked #8	72.5
9 (tie)	IL	760 ILCS 3.0/12	Yes	Yes	No	No	Yes	No	Ranked #11	Not allowed	72.5
11	IN	§30-4-3.36	Yes	Yes	Yes	No	Silent	Silent	Unranked	Ranked #10	71
12 (tie)	SC	§62-7-816A	Yes	Yes	No	Yes	Yes	No	Unranked	Not allowed	70
12 (tie)	TX	§811.2071 to 112.082	Yes	Yes	No	No	Yes	Yes	Unranked	Not allowed	70
14	WY	§10-816(a)(xxviii)	Yes	No	Yes	Silent	Silent	Silent	Ranked #5 (tie)	Ranked #12	69
15	RI	§ 8.4-31	Yes	Yes	Silent	No	Silent	No	Ranked #5 (tie)	Ranked #9	66.5
16	FL	§76.04117	Yes	Yes	No	No	Silent	Silent	Ranked #12	Not allowed	66
17 (tie)	AL	§19-3D	Yes	Yes	No	No	Yes	No	Unranked	Not Allowed	65

WARNING: THIS 8TH ANNUAL TRUST DECANTING STATE RANKINGS CHART IS MERELY A GUIDE. THE USER MUST BE SURE TO ACCESS THE ACTUAL DECANTING STATUTE AND READ THE TRUST PROVISIONS RATHER THAN SIMPLY RELYING ON THIS CHART.

*The Dynasty Trust State Ranking column is based on the 9th Annual Dynasty Trust State Rankings Chart and the Domestic Asset Protection State Rankings Chart is based on the 11th Annual Domestic Asset Protection State Rankings Chart, both at <http://www.oshins.com/state-rankings-charts>.

*This Trust Decanting State Rankings Chart created in April 2021. Original Trust Decanting State Rankings Chart created in January 2014.

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