WRMarketplace
An AALU Washington Report

Thursday, May 29 2014 **WRM# 14-21**

The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Decanting – Giving New Life to Old Trusts.

MARKET TREND: Clients want to incorporate flexibility into their trust planning, and the trustee's ability to decant an irrevocable trust can be a big part of that flexibility, particularly for dynasty trusts created in states with extended or repealed rules against perpetuities.

SYNOPSIS: Generally, decanting is a statutorily authorized process that allows a trustee to transfer assets from an existing irrevocable trust to a new or another existing irrevocable trust, which may have different terms. Decanting can provide an efficient alternative to expensive judicial trust modification proceedings and may be used to achieve a wide range of goals, from correcting drafting errors, to changing distribution standards, to granting powers of appointment. Decanting is a developing area of law, with 22 states having adopted decanting statutes to date.[1] The process, however, is highly dependent on state law requirements, may create potential tax consequences, and can raise fiduciary issues.

TAKE AWAYS: Decanting has modified the scope of irrevocability for trust planning purposes. Draft trust agreements, particularly for dynasty trusts, now should include all the flexibility permitted for decanting if the client is comfortable with the concept, since it allows trustees to adapt to changing beneficiary needs and/or tax, legal and economic circumstances over the long-term. Although decanting is a powerful tool for modernizing and optimizing impractical trusts, trustees and their advisors must proceed carefully and thoroughly analyze the applicable state law requirements, the existing trust provisions, and the potential tax ramifications and fiduciary issues before undertaking the decanting process. The trustees involved generally will want to avoid adverse tax consequences and must ensure compliance with their fiduciary duties. In most cases, having an independent/non-interested trustee decide on and effectuate the decanting of an existing trust, even if not required under state law, will be the preferred way to proceed.

PRIOR REPORTS: 12-2.

MAJOR REFERENCES: *Notice 2011-101, 2011-52 I.R.B. 932*

Modifying an irrevocable trust can be an expensive and time consuming endeavor, and, in the past, typically required court approval. These judicial proceedings risked denial of the proposed alterations if they were deemed to impede a material purpose of the trust and required public disclosure of private family information, arguably placing the trustees at risk.

Now, however, a growing number of states[2] have adopted the process of "decanting" as a mechanism to update an irrevocable trust that has become outdated or no longer serves its intended purpose, often without requiring judicial review. Decanting generally allows the trustee of an existing trust to transfer assets to a different "receiving" trust (new or existing), which has terms better suited to meet the distributing trust's overall goals or to adapt to changing beneficiary needs and/or tax, legal and economic circumstances.

AUTHORITY TO DECANT

The authority to decant primarily stems from state statutes. To date, 22 states have adopted statutes authorizing trustees to decant the assets of an existing trust to a receiving trust. In a few other states, decanting authority is based on case law holding that a trustee's power to apply principal "for the benefit of" a beneficiary enables the trustee to decant trust assets to a receiving trust benefiting that beneficiary. Further, many trust agreements now specifically authorize trustees to distribute assets in further trust for the beneficiaries.

Some states, however, still do not authorize decanting. Yet, it may be possible for irrevocable trusts in those states to obtain decanting benefits by changing the state law applicable to the trust. For example, depending upon the trust and applicable state law, a trust may be able to take advantage of a preferred state's decanting statute by moving its situs to the preferred state or by simply adding a co-trustee that resides in that state.

WHAT CAN DECANTING ACCOMPLISH?

With irrevocable life insurance trusts ("**ILITs**") holding millions of dollars of face value in policies, and other dynasty trusts holding large portions of family assets, there is an immense amount of wealth tied up in irrevocable trusts that may no longer serve their intended purposes. For this and numerous other reasons and benefits, decanting may be the answer for these trusts, including as follows:

Transferring Life Insurance Policies and Other Assets. Previously, transferring existing trust-owned life insurance ("**TOLI**") policies to a different trust generally required a sale of the policy from one trust to the other. With decanting, however, a trustee of an existing trust can transfer TOLI polices and/or other assets to a receiving trust without a sale, avoiding the need for policy or asset valuations, the need to fund the purchasing trust (though gifts, loans, etc.) with money to buy the TOLI policy/other assets, etc.

Extend the Date the Trust Terminates. Many trusts contain mandatory distribution provisions that require the distribution of trust principal, in whole or part, to the beneficiary at specified age(s). For example, a trust may require the trustees to distribute all principal to a beneficiary at age 21, or in thirds at certain ages (*e.g.*, 25, 30 and 35). Once the beneficiary receives the assets outright, those assets lose the creditor and other protections afforded by the trust.

If allowed under applicable state law and the existing trust terms, a trustee could decant these assets into a receiving trust that delays the ages for distributions or even holds the assets in trust for the beneficiary's lifetime. The receiving trust also could include provisions that incentivize

beneficiaries or prevent distributions to them in the case of substance abuse or if a beneficiary is unable to independently manage his or her finances. The ability to change distribution provisions in an ILIT is particularly important if the settlor becomes uninsurable and setting up a new trust with a new policy is no longer a viable option.

Changing Grantor / Non-Grantor Trust Status. Decanting also can be used to convert a non-grantor trust into a grantor trust for income tax purposes or vice versa.[3]

Segregating Assets or Splitting Trusts. Trustees can use decanting to split assets into separate trusts, for example to segregate certain classes of assets, or, in the case of TOLI policies, to move a first-to-die life insurance policy out of a second-to-die ILIT, etc.

Decanting also can help mitigate controversies that often arise in connection with "pot" trusts, which simultaneously benefit multiple beneficiaries from multiple generations. Over time, these trusts can cause family discord over the equality of distributions among beneficiaries or the trust's investment strategy. A trustee could decant the pot trust assets into separate receiving trusts for the various family groups, allowing each branch to monitor the distributions and investments of their own trust.

Consolidating Assets or Trusts. On the other hand, sometimes multiple trusts have been created over the years for a single beneficiary or group of beneficiaries. Each trust will have its own checking and brokerage accounts, investment strategy, income tax filings, trustee's fees and other administrative needs and expenses. Decanting can be used to consolidate the assets of the multiple trusts into a single receiving trust, which may reduce administrative costs, simplify the administration process, increase the investing power of the receiving trust, and achieve more efficient overall management.

Modify Trustee Provisions. Successor trustee provisions in older trusts often fail to provide a mechanism for the appointment or removal of trustees, or simply fall back on a direction for a court to appoint a successor trustee. The receiving trust used in a decanting can include a trust protector or other mechanism to appoint additional and successor trustees, and/or remove trustees, without requiring an expensive and public court proceeding. In addition, depending upon the law governing the administration of the trust, the receiving trust can divide fiduciary responsibilities among trustees, for example by making different co-trustees responsible for each of the distribution, investment management, and administrative powers.

Update or Change Administrative Provisions. Decanting can be used to change the trust's situs and governing law to a state that provides more favorable state tax treatment, creditor protection, or other advantages.

Modify or Eliminate Investment Restrictions. Some trusts may be drafted with very restrictive investment authority for the trustees (*e.g.,* the trust document may prohibit the acquisition of life insurance or restrict investments to government bonds or blue chip stocks). Decanting can be used to add provisions in the receiving trust that authorize the trustee to purchase life insurance, to enter into split dollar arrangements, or to engage in other life insurance planning transactions. The receiving trust also can eliminate or relax investment restrictions and enable the trustee to diversify the investment portfolio to take into account economic changes and each beneficiary's current needs and circumstances.

Modify Distribution Standards. Many trusts restrict the trustee's authority to distribute income and principal to an ascertainable standard, such as the health, education, maintenance and

support of the beneficiaries. In some states, these "support trusts" can be reached by certain creditors, or the beneficiary himself may be able to force distributions for his support. Depending on applicable state law and the trust document, a trustee of such a support trust could decant to a fully discretionary receiving trust, making it harder for creditors to reach trust assets.

FIDUCIARY AND TAX IMPLICATIONS OF DECANTING

From a fiduciary perspective, the trustees involved in the decanting of an existing trust to a receiving trust will want to review their fiduciary obligations carefully and ensure their actions do not breach any of their fiduciary duties to the existing trust or any of its beneficiaries (e.g., duties of loyalty to, and impartiality among, beneficiaries).

For tax purposes, decanting is relatively new, and the federal and state tax consequences are unclear. Further, the IRS has included certain decanting issues in the list of topics on which it will not issue private letter rulings or determination letters.[4] These issues include whether a change in beneficial interests resulting from: (1) the distribution of property from one irrevocable trust to another creates a taxable gift, or (2) the distribution of accumulated income from one irrevocable trust to another requires inclusion of the income in the gross income of any beneficiary of either trust.

In December 2011, the IRS issued Notice 2011-101[5] requesting comments regarding when, and under what circumstances, changes in beneficial interests resulting from decanting assets from one irrevocable trust to another will not trigger income, gift, estate and/or generation-skipping transfer ("**GST**") taxes. The facts and circumstances identified by the IRS as potentially having tax consequences provide insight into the possible tax implications of decanting and include:

- A change in a beneficiary's right to or interest in trust principal or income;
- If trust principal and/or income may be used to benefit new (additional) beneficiaries;
- When a beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed;
- When the transfer is from a grantor trust to a non-grantor trust, or vice versa;
- Where the situs or governing law of the new trust differs from that of the original trust, resulting in a termination date of the new trust that is later than the termination date of the original trust;
- If the beneficiaries are required or not required to consent to the transfer by the terms of the original trust and/or applicable local law;
- If consent of the beneficiaries and/or a court order (or approval of the state Attorney General) is not required but is obtained;
- The effect of state law or the silence of state law on any of the above scenarios;
- A change in the identity of a donor or transferor for gift and/or GST tax purposes;
- If the original trust is exempt from GST tax; and
- If none of the above changes are made, but the new trust includes a future power to make any such changes.

Other tax issues that need to be considered include:

- Whether transfers from a distributing trust to a receiving trust trigger capital gains;
- Whether the new trust assumes the tax attributes of the original trust;

- Whether accumulated income transferred to the new trust will trigger tax to the recipient;
- Whether requiring the consent of the trust's beneficiaries to the decanting will result in a taxable gift;
- Whether, if the settlor of the distributing trust is living, any estate tax inclusion issues arise when the distributing trust decants assets to a receiving trust with differing distribution terms or changes in beneficial interests; and
- Whether decanting a trust that qualifies for a marital or charitable deduction will result in a loss of the deduction.

Particular care also must be given to a trust that is grandfathered for GST taxes purposes or is otherwise exempt from GST taxes, as a wrong step could result in a deemed constructive addition to the trust and cause all or part of the trust to be subject to GST taxes.

A detailed discussion of the various unresolved tax issues is beyond the scope of this report. Until more guidance is issued by the IRS, the potential tax consequences of decanting a specific trust must be carefully analyzed before proceeding. However, for these and other reasons, in most cases, having an independent/non-interested trustee decide on and effectuate the decanting of the existing trust to a receiving trust will be the preferred course of action, even if not required by applicable state law.

DECANTING REQUIREMENTS AND RESTRICTIONS

Decanting procedures, requirements, and restrictions vary widely by state. Trustees and their advisors must carefully analyze applicable state statutes, case law and the trust instrument itself to ascertain the process and steps required to decant a specific trust. Some of the variations and issues to consider are highlighted below.

- Most decanting statutes prohibit adding beneficiaries to the trust (although a work-around may be possible).

- Some states, such as Delaware, South Dakota and Nevada, do <u>not</u> require the trustee to notify the beneficiaries of the trustee's intent to decant trust assets to a receiving trust. Other states, however, require notification of certain or all trust beneficiaries.

- While some states require beneficiary consent to a proposed decanting, <u>most do not</u>.

- Some states allow a trustee to decant only if the trust is fully discretionary (*i.e.*, principal distributions are not limited to an ascertainable standard, such as health, education, maintenance and support). Other states authorize decanting even if the trustee's authority to distribute principal is limited to an ascertainable standard and the receiving trust is fully discretionary. In some states, decanting is permitted only if the trustee has authority to distribute principal; authority to distribute only trust income will not suffice.

- Generally, decanting will not be permitted if it will change a beneficiary's vested interest under the distributing trust (*e.g.*, if the beneficiary is currently entitled to trust income or has an existing right to withdraw a portion of the trust's assets) or result in the loss of an existing marital or charitable deduction.

TAKE-AWAYS

- Decanting has modified the scope of irrevocability for trust planning purposes.

- Draft trust agreements, particularly for dynasty trusts, now should include all the flexibility permitted for decanting if the client is comfortable with the concept, since it allows trustees to adapt to changing beneficiary needs and/or tax, legal and economic circumstances over the long-term.

- Although decanting is a powerful tool for modernizing and optimizing impractical trusts, trustees and their advisors must proceed carefully and thoroughly analyze the applicable state law requirements, the existing trust provisions, and the potential tax ramifications and fiduciary issues before undertaking the decanting process. The trustees involved generally will want to avoid adverse tax consequences and must ensure compliance with their fiduciary duties.

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[1] Decanting statutes have been adopted in Alaska, Arizona, Delaware, Florida, Indiana, Kentucky, Illinois, Missouri, Michigan, New Hampshire, New York, North Carolina, Nevada, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Wisconsin and Wyoming.

[2] *Id*.

[3] As noted herein, this decanting would be subject to consideration of the potential income tax issues, including whether conversion to non-grantor trust status through decanting results in income tax liability or recognition of gain on the decanted trust assets (to the distributing or the receiving trust), whether a carry-over tax basis will apply in the hands of the receiving trust; whether the grantor of the distributing trust continues to be a grantor after decanting, etc.).

[4] Rev. Proc. 2011-3, 2011-1 I.R.B. 111.

[5] Notice 2011-101, 2011-52 I.R.B. 932.

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