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ESTATE PLANNING MEMORANDUM

TO: **CPAs, Clients & Associates**

FROM: **David L. Silverman, Esq.**
Shirlee Aminoff, Esq.

DATE: **April 2, 2010**

RE: **Modifying or "Decanting" Irrevocable Trusts**

I. Introduction

Despite the best efforts of drafters to contemplate unforeseen circumstances, situations arise where dispositive trust provisions may not reflect the present circumstances of beneficiaries. If the trust is revocable, and the grantor is alive, the grantor may revoke or amend the trust. However, trusts are often made irrevocable for tax or asset protection purposes. In those cases, revoking the trust, while not impossible, may be extremely difficult, especially if minor beneficiaries are involved. Under the Uniform Trust Code, a noncharitable irrevocable trust may be modified with court approval "upon the consent of all beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust." The settlor, a beneficiary, or a trustee may initiate an action to modify an irrevocable trust. However, the court may approve the modification only if

all of the beneficiaries have consented and the interests of all beneficiaries who have not consented will be adequately protected.

Where trust modification under the UTC or under common law is either not possible — or even where it is possible, but unattractive — modification under a "decanting" statute may be preferable. New York was the first state to enact a "decanting" statute, which effectively permits the trustee acting alone to amend the terms of an irrevocable trust. The most important prerequisite to utilizing New York's decanting statute, found in EPTL §10-6.6(b), is that the original trust must contain language granting the trustee absolute discretion with respect to making trust distributions to beneficiaries. If the original trust only grants the trustee discretion to make distributions in accordance with an ascertainable standard (i.e., for the beneficiary's health, education, maintenance or support), or even if the trustee is given absolute discretion to make distributions, but only for the beneficiary's comfort, then EPTL §10-6.6(b) cannot apply, and the original trust cannot be decanted or distributed into a new trust.

Another limitation of EPTL §10-6.6(b) is that the fixed income right of any beneficiary cannot be reduced by reason of the decanting. This limitation has been construed as being applicable only to a named beneficiary identified in the trust instrument as having a right to income for a fixed period of time. One purpose of this requirement is to ensure that the marital deduction for estate and gift tax purposes is preserved, since the surviving spouse must have a right to all of the income during her life from the trust to ensure the availability of the deduction.

The procedure for invoking EPTL §10-6.6(b) is straightforward: First, the trustee must sign a notarized document which effectuates the decanting. Second, the document must be filed with the court having jurisdiction over the trust. Third, the trustee must serve a copy of the acknowledged instrument upon "all persons interested in the trust." All persons interested in the trust are essentially those who would be required to be served in a judicial accounting. See EPTL §10-6.6(b). While court approval is not required, the trustee may seek court approval if he is unsure as to whether the decanting statute applies, or if he is concerned with potential exposure from claims made by recalcitrant or litigious beneficiaries.

[Under the decanting statutes of Delaware and Alaska, the trustee of the original trust need only have authority to invade trust principal. Absolute discretion is not required. Del. Code Ann. title 12 § 3528; Alaska Stat. § 10-6.6(b)(1). If a trust situsedin New York does not grant the trustee absolute discretion to make distributions, it might be possible to change the governing law of the trust instrument to avail the trustee of the more favorable Delaware statute. Under the Delaware statute, if the statutory prerequisites are met, a trustee may decant trust property in favor of a new trust without court approval and even without notice to or consent of beneficiaries. However, a written instrument signed and acknowledged by the trustee must be filed with the records of the trust.]

II. Circumstances Favoring Decanting

A trustee might seek to utilize EPTL §10-6.6 to accomplish any of the following objectives: (i) to extend the termination date of the trust; (ii) to add or modify spendthrift provisions; (iii) to create a supplemental needs trust for a beneficiary who is or has become disabled; (iv) to consolidate multiple trusts; (v) to modify trustee provisions; (vi) to change trust situs; (vii) to correct drafting errors; (viii) to modify trust provisions to reflect new law; (ix) to reduce state income tax imposed on trust assets; (x) to vary investment strategies for beneficiaries; or (xi) to create marital and non-marital trusts.

For example, an irrevocable trust might provide for a mandatory distribution of principal at age 25, with final principal distributions at age 30. However, such mandatory distributions might be inadvisable if the beneficiary has creditor problems, or is profligate or immature. In In re Rockefeller, NYLJ Aug. 24, 1999 (Surr. Ct. N.Y. Cty.), the Surrogate allowed trust assets to be decanted into a new trust which contained a spendthrift provision. The beneficiary may have become subject to a disability after the trust had been drafted. To become (or maintain) eligibility for public assistance, it might be necessary for the trust assets to be distributed to a supplemental needs trust. The Nassau Surrogate, in In Re Hazan, NYLJ Apr. 11, 2000 authorized the trustee of

a discretionary trust to distribute assets to a supplemental needs trust whose term had been extended, to enable the beneficiary to continue to be eligible for public assistance.

If more than one trust has been created for a beneficiary, overall liquidity may be enhanced by transferring the assets of one trust into another trust. So too, combining multiple trusts into a single trust may greatly reduce administrative expenses. In In Re Vetlesen, NYLJ June 29, 1999 (Surr. Ct. N.Y. Cty.), the court authorized the trustee to appoint trust assets to a testamentary trust with identical provisions to reduce administrative expenses. EPTL §10-6.6(b) is particularly well suited to address problems where it may be desirable to appoint new trustees. In re Klingenstein, NYLJ, Apr. 20, 2000 (Surr. Ct. Westchester Cty.) authorized the decanting of assets into multiple trusts which granted the beneficiary of each trust the power to remove the trustee. The creation of new trusts in Klingenstein also allowed the removal of the impractical limitation requiring any trustee acting as sole trustee to appoint a corporate co-Trustee, and allowed for the elimination of successor Trustee appointments. The decanting statute could also be utilized to modify trustee compensation.

EPTL §10-6.6(b) may also be utilized to change the situs of a trust for privacy reasons. The grantor of a trust may not want child beneficiaries to become aware of the trust. To preserve secrecy, the trustee might wish to change the situs of the trust to Delaware, which limits the trustee's duty to disclose. If trust property is also located out of New York, changing the situs of the trust might also facilitate trust administration. Drafting errors or changes in the tax law may also be occasions for seeking to distribute trust assets into a new trust. The Surrogate in In re Ould Irrevocable Trust, NYLJ Nov. 28, 2002 (Surr. Ct. N.Y. Cty.) authorized the transfer of trust assets into a new trust where the retention of certain powers by the insured in the original trust may have resulted in estate tax inclusion.

Tax considerations may provide another compelling reason for decanting trust assets. Under NY Tax Law §603(b)(3)(D), even if the trust is situsedin New York, if there is (i) no trustee domiciled in New York, (ii) no New York source income, and (iii) no real or tangible property located in New

York, then accumulated income and capital gains will not be subject to New York income tax. Accordingly, if a trust sitused in New York holds considerable assets outside of New York, decanting those assets into a trust in another jurisdiction might avoid New York income tax on capital gains and accumulated income sourced outside of New York.

If a single trust contains many beneficiaries, one investment strategy might not satisfy the differing objectives and needs of each beneficiary. Splitting the trust into individual trusts for each beneficiary might enable the trustees to manage each trust in accordance with the differing objectives of each beneficiary. The Surrogate in In Re Estate of Scheuer, NYLJ July 10, 2000 (Surr. Ct. N.Y. Cty.) authorized the trustees of the original trust to appoint trust assets into ten new trusts to accomplish this objective.

Federal tax considerations may also warrant consideration of EPTL §10-6.6(b). For example, the statute could be used to create GST Exempt and GST Non-Exempt trusts. Investment strategy for the GST Exempt trust — which would not be subject to GST tax — could be aggressive, while investment strategy for the GST Non-Exempt trust could be used to make distributions to children who are exempt from the GST tax. For example, these distributions could be made for tuition or medical care. [PLR 200629021 ruled that dividing a GST exempt trust into three equal trusts to facilitate investment strategies for different beneficiaries would not taint GST exempt status.]

Dividing a trust into marital deduction and nonmarital deduction trusts may also yield both tax and nontax benefits. Assets decanted into the marital deduction trust, which would ultimately be included in the estate of the spouse, could be invested in conservative securities and could be used for distributions of principal to the spouse. To the extent the marital trust is depleted, the amount of assets ultimately included in the spouse's gross estate would be reduced. Assets in the nonmarital trust, which would not be subject to estate tax in the estate of the spouse, could be in invested in growth assets for future beneficiaries.

III. Tax Consequences of Decanting

A. Transfer Tax Consequences

A GST Exempt Trust is not subject to Generation Skipping Transfer Tax. Treas. Reg. §26.2601-1(b)(v)(B) states that the extension of an Exempt Trust in favor of another trust will not trigger GST tax. However, actual additions or deemed additions to a GST Exempt Trust would cause it to lose its exempt status. Therefore, care must be taken when utilizing EPTL §10-6.6(b) not to make an actual or deemed addition to the trust which would cause a GST Exempt Trust to lose its exempt status. If GST implications resulting from distributions to a new trust under EPTL §10-6.6(b) are unclear, a private letter ruling from the IRS should be obtained in advance.

The IRS could argue that decanting causes a taxable gift by the beneficiary to the trust. If the beneficiary is entitled to receive trust distributions at a certain age, and by reason of decanting, the assets are held in trust for a longer period, the IRS could make the argument that the right of the beneficiary to receive trust assets at a certain age is equivalent to a general power of appointment. If the beneficiary fails to object to the decanting, the beneficiary has, in effect, released a general power of appointment, which would result in a taxable gift. The problem with this argument is that since the beneficiary likely does not have the right to object to the decanting, the beneficiary possesses no general power of appointment over trust assets. The beneficiary cannot release a power he does not possess.

However, if the beneficiary could forestall an attempt by the trustee to decant, then the gift argument gains credibility. To weaken the argument that a taxable gift has occurred, the beneficiary could be given a limited power over trust assets in the new trust. The retention of a limited power of appointment generally should prevent the release from being a taxable gift. Treas. Reg. §25.2511-2(b).

B. Income Tax Consequences

Decanting should result in no adverse income tax consequences. For gain or loss to occur,

there must be either a sale or exchange of property, or the property received must be materially different from the property surrendered. Treas. Reg. §1.1001-1(a). The Supreme Court in Cottege Savings Ass'n v. Com'r., 499 U.S. 554 (1991) seemed to read out the word "materially" from the term "materially different" in holding that an exchange of similar mortgages triggered a taxable event. Nevertheless, the IRS has stated in recent rulings that a distribution in further trust will not trigger income tax provided the distribution is permitted either by the trust instrument or by local law.

If encumbered property is distributed pursuant a decanting statute, a potential income tax problem could arise under Crane v. Com'r., 331 U.S. 1 (1947), since that case held that the amount realized includes relief from liability. However, IRC §643(e) provides that distributions from a trust generally do not produce taxable gain. Therefore, substantial authority would appear to exist for the reporting position that decanting produces no realized even if liabilities exceed basis. In view of the preparer penalties under IRC §6694, practitioners might consider disclosing the position on the return.

The decanting statutes of all states provide that the ability to decant trust assets into a new trust is the default rule, but that the default rule may be overridden by the trust instrument. Therefore, the grantor may wish to include in newly drafted trust instruments a provision which specifically addresses his wishes with respect to future trust decanting. The grantor may wish to limit the trustee's future ability to modify the trust or may wish to give the trustee carte blanche to decant. In either case, specific reference to the grantor's wishes should be included in the trust instrument.