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ESTATE PLANNING M E M O R A N D U M

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RE: New York's Revised Decanting Statute Under EPTL §10-6-6

Under the Uniform Trust Code and EPTL §10-6.6, 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 EPTL or under common law is either not possible — or even where it is possible, but unattractive — modification under New York's "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.

"Decanting" statutes in some jurisdictions, such as Delaware and Alaska, permit the appointment of irrevocable trust assets into a new trust where the trustee has significant — but not absolute — discretion with respect to distribution of trust assets. Former EPTL §10-6.6(b) had required that the trustee have unlimited discretion to invade principal in order to vest trust assets in a new irrevocable trust. Therefore, an "ascertainable standard" trust established in New York could not have availed itself of New York's decanting statute. However, New York in 2011 joined states such as Delaware and Alaska, and now permits decanting even where the trustee has only limited discretion. The potential uses of decanting are manifest: 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.

Where Trustee Has Unlimited Discretion to Invade Principal

Under amended EPTL §10-6.6(b), if the trustee has unlimited discretion to invade trust principal in favor of "current beneficiaries," the decanting statute now allows the trust into which the assets are decanted, the "appointed trust," to benefit one or more beneficiaries to the exclusion of other beneficiaries. The rationale for this regime appears to be that if the trustee has unlimited discretion to invade principal in favor of one beneficiary, appointing all of the trust assets into a new trust which benefits only that person accomplishes the same result.

Where Trustee Has Limited Discretion to Invade Principal

Under EPTL §10-6.6(c), where the trustee has only limited discretion to invade principal, the appointed trust must have identical current and remainder beneficiaries as the invaded trust. Furthermore, the standard which guides the trustee in the appointed trust must be identical to that in the invaded trust for the duration of the original trust term. For example, if the invaded trust provided for principal distributions for the beneficiaries' "health, education, maintenance and support" (*i.e., the "HEMS"" standard),* then the appointed trust may not deviate from this standard. Similarly, if the invaded trust were set to terminate when the beneficiary reached the age of 50, and required that the HEMS standard be utilized during the entire duration of the trust, statutory compliance would require that the discretion given to the trustee of the appointed trust be limited to the HEMS standard until the beneficiary reached the age of 50. For any period that assets are held in the appointed trust after the beneficiary reaches the age of 50, the discretion of the trustee may be unlimited.

Fixed Statutory Directives

As a prelude to the discussion of formal statutory requirements, it should be noted that the amended statute has dispensed with the requirement of court filing except in specific circumstances. Court filing is now required only for trusts which have been subject to prior court proceedings. The procedure for invoking EPTL §10-6.6 is straightforward: Under the revised statute, notice must be given to "all persons interested in the trust," and no trust may be invaded until 30 days after notice has been given. During this 30-day period, any interested party may object to the decanting by written notice of objection to the trustee. The invaded trust may be decanted immediately if all interested parties waive the 30-day notice period. The class of persons "interested" has been expanded, and now includes — in addition to those persons who would be required to be served with a trust accounting — the settlor of the invaded trust and any person who could remove the trustee (e.g., a "trust protector").

The power of a trustee to decant is not dependent upon the consent of the beneficiaries. Therefore, even a timely objection by a beneficiary to a proposed decanting will not nullify the power of the trustee to decant. Conversely, the failure of a beneficiary to formally object within the 30-day notice period does not operate as a waiver of the beneficiary's right to object at a later date. Presumably, at that point Court involvement would be necessary. Another limitation of EPTL §10-6.6 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.

Fiduciary Considerations

Regardless of the degree of discretion given to the trustee with respect to distributions of principal, no trust may be invaded if there is evidence that the invasion would be contrary to the intent of the creator. A corollary of this rule is that any trust may explicitly state that the trust may not decant. In deciding whether to exercise a power to decant, the statute cautions that decanting should only be undertaken if a prudent person would consider it to be in the best interests of one or more, but not necessarily all, of the beneficiaries. No trustee has an affirmative duty to decant, even if decanting would be in the best interest of the beneficiaries. A trustee who does exercise the power to decant is under an affirmative duty to consider possible tax implications.

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 (Sur. 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) eligible 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 (Surrogates 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 is particularly well suited to address problems where it may be desirable to appoint new trustees. In re Klingenstein, NYLJ, Apr. 20, 2000 (Surrogates 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 may also be utilized to change the situs of a trust for privacy reasons. The grantor of a trust may not want beneficiaries who are minors 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 (Surrogates 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. 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.

New York State Tax Considerations

Tax considerations may provide another compelling reason for decanting trust assets. Under NY Tax Law §603(b)(3)(D), even if the trust is sitused in 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 New York trust 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.

Federal Estate Tax Considerations

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. 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 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 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. Thus, 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. This argument is less cogent in states like New York, where the beneficiary does not have the power to prevent the decanting. However, if a 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).

Federal Income Tax Considerations

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 Cottage 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.

IRS Interest in Decanting Statutes

In December of 2011, the IRS announced that it was considering the tax implications of trust decanting. Notice 2011-11. Among the tax implications the IRS is considering are (i) the addition of new beneficiaries; (ii) the conversion of a grantor trust to a non-grantor trust (and vice versa); (iii) the effect of consent of beneficiaries; (iv) whether the consent of a beneficiary to decant carries with it gift tax consequences; and (v) whether trust decanting constitutes a recognition event for income tax purposes.