

Decanting an irrevocable trust: Are these trusts really irrevocable?

If revocable trusts are not irrevocable, could irrevocable trusts be revocable? Under the decanting statute in New York Estates, Power and Trusts Law ("EPTL") § 10-6.6(b), trustees and beneficiaries of an irrevocable trust can decide to modify the trust without the need for court intervention. By "decanting a trust," trust assets from the irrevocable trust are poured into another trust, whose terms may be different from the first trust, providing many benefits which once seemed unattainable. The decanting statute is applicable to inter vivos and testamentary trusts. The "new" trust designated to receive the trust assets may be formed anew or may be a trust formed under the old instrument. To be sure, not every irrevocable trust can be decanted, nor can all of the terms and objects of the trust be changed, as we shall see.



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Why and When to Decant a Trust

One difficult issue which arises due to the immutable nature of irrevocable trusts is the choice of applicable law. Circumstances might have changed since the trust instrument was drafted, whereby the original choice of law may no longer be the optimal choice to facilitate the goals of the trust. One experienced in drafting with foresight of such a scenario might insert language into an irrevocable trust which allows for certain amendments at a later date, so that the trust need not rely upon the statutes of a particular state. The New York decanting statute precludes the need for such language, allowing the trust terms to be modernized and placed in conformity with the present needs of the settlor or beneficiaries of the trust. *Matter of Riese*, 627 NYS2d 1028 (Surr. Ct. NY County 1995).

Significant alteration is permitted within the guidelines of the decanting statute. Decanting allows one to not just make alterations to correct drafting errors, but even to change the type of trust. An irrevocable trust which was a grantor trust can be decanted into a non-grantor trust, or vice versa, to provide fiduciary income tax benefits. Decanting can assist the funding of life insurance trusts, especially when there are multiple trusts, some of which have liquidity, while others have obligations, to strategically pour them into one trust. Under some circumstances, a per stirpes dispos-

itive provision may be switched to a per capita distribution division. Spendthrift provisions may be added to, or removed from, the trust instrument. Even extending the termination date of trusts may be possible. *In re Alfred Hazan*, NYLJ June 19, 1999, p. 27, col. 3.

Decanting a trust can be an instrumental means of improving the trust's governance structure. The statute allows for substantial room to alter the trust provisions pertaining to the authority of the trustees. The new trust need not have the same trustees as the old trust. The optimal management of the trust might require the adjustment of certain administrative terms in order to aid the fiduciaries' performance. For example, trustees are responsible for meeting a standard with regard to investing and managing trust assets. By appointing an investment director to be in charge of this aspect of trust management, the trust funds can be better managed and the trustee will be less exposed to personal liability for such investment decisions. The trust can even be poured into separate trusts, where based upon risk and other investment factors, beneficiaries can have the new trusts better suit their financial needs. However, court approval is required to increase the amount of trustee commissions. EPTL § 10-6.6(c).

EPTL Requirements

The NY EPTL § 10-6.6(b)(1) lists four statutory prerequisites which offer much direction, but also leave many questions unanswered. The first prerequisite in order to qualify for this decanting statute is that the trustee must have absolute discretionary distribution authority to invade the principal of the trust and to distribute the trust property. Therefore, this requirement will not be met where the trustee's power to distribute the trust corpus is limited by an ascertainable standard. For example, if the trustee's distribution authority is restricted to the health, education, maintenance, support or general comfort of the beneficiary, the trust cannot be decanted under the New York decanting statute. *In the Matter of the Estate of Gerald Mayer, Deceased*, 176 Misc. 2d 562 (Surr. Ct. New York County, 1988).

A second prerequisite to decant the trust mandates that the exercise of the

power cannot reduce any fixed income interest of any income beneficiary of the trust. This means that income beneficiaries who were specifically identified to receive income for a set amount of time must continue to receive the trust income, as defined under the terms of the original trust. The beneficiaries' interests probably do not have to be identical in both trusts, but this point has been argued in both directions.

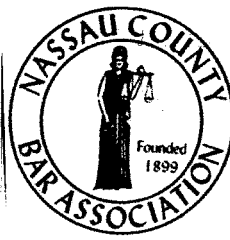
The third criteria requires that the exercise of the trustee's power be in favor of one or more proper objects of the exercise of the power. Since the power to invade the trust res is analogous to a power of appointment, the powers of appointment are also limited by the terms of the underlying trust agreement. Therefore, a donee of a power of appointment can only appoint someone who is within the class of permissible appointees, as defined by the terms of the trust. However, this is not always a hard and fast rule. In a case where the trustee has the power to distribute all of the trust property to one beneficiary, that beneficiary can be given the power of appointment to enlarge the class of permissible appointees, thereby including persons whom were once outside the reach of the irrevocable trust. It is unclear to what extent the nature of the beneficiaries' interests in the old trust can be changed, especially when dealing with the rights and order of distributions of a remainderman.

The last prerequisite in the statute provides that the new trust cannot contain certain provisions which violate the limitations of EPTL § 11-1.7. EPTL § 11-1.7 places limitations on the powers and immunities of testamentary trustees which run contrary to public policy. Thus, the trustee can not be exonerated from his fiduciary liability for failure to exercise reasonable care, diligence and prudence. In addition, the trustee can not be given the power to "make a binding and conclusive fixation of the value of any asset for purposes of distribution, allocation or otherwise." *Id.*

How to Decant a Trust

As mentioned above, the trustee does not need court approval or beneficiary consent to decant the trust. All the trustee must do is sign and acknowledge a document, exercising the power to decant the trust, and file it with the Surrogate's Court. Any one "interested in the trust" (that would be served in an accounting of the trust pursuant to

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EPTL § 11-1.11(g)) needs to be served with a copy of the effectuating document. If a trustee is unsure whether the statutory provisions have adequately been met and would like the court approval to make the process more formal, the same procedure as described above would be carried out. EPTL § 10.6.6(c)

Potential Tax Issues

As with the drafting of most trusts, tax planning should be an integral part of the consideration of the trustee with respect to decanting. A particularly complex issue is whether extending an irrevocable trust under the New York decanting statute will affect the previous allocation of generation skipping tax (GST) exempt status. There have been numerous private letter rulings and treasury regulations which address this issue, attempting to provide guidance, but the path is currently far from clear. (*e.g.* Treas. Regs. § 26.2601-1(b)(4), PLR 9848043, 200420011; *see also* Alan Halperin and Michelle R. Wandler, *Decanting Discretionary Trusts: State Law and Tax Considerations*, 29 *Tax Management Estates, Gifts & Trusts Journal*, 219, 221 (2004)).

Decanting an irrevocable trust should not incur income tax as it is not a recognition event. The transfer of assets from one trust to another is not a sale or exchange of property, nor is the property received materially different from that which was given. Treas. Regs. § 1.1001-1(a). However, if the distribution from the old trust causes there to be a relief of liabilities (*e.g.* encumbered property) there might be a recognizable gain. Also, if a part of the trust property being transferred is an appreciated asset, and it is being poured into a foreign trust, which is not a grantor trust, such a transfer would be treated as a sale or exchange under § 684 of the IRC.

Decanting a trust has gift and estate tax implications which require careful consideration. One issue is whether the trustee's exercise of the power should result in a taxable gift to the beneficiary. Assuming the trustee is not a beneficiary, it can be argued that since the gift is initiated by the trustee and because beneficiary consent was not required, this would not qualify as a gratuitous transfer. However, since the beneficiary had expected to receive the gift and failed to object to the transfer of trust assets to the new trust, these two factors support

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the claim that this would be a taxable gift. To help avoid this issue, under the new trust the beneficiary should be given a limited testamentary power of appointment, making the gift incomplete and not taxable. Altering the terms in the new trust can provide many state tax benefits as well, such as effectively avoiding state fiduciary income tax or limiting exposure to state real property transfer tax.

In conclusion, decanting an irrevocable trust can be a viable solution to many "dead end" predicaments, providing new and alternative options. Just as there are

many situations in which decanting a trust can be advantageous, there are many resulting issues and tax concerns that need to be addressed. Utilized appropriately, with the proper tax and estate planning, decanting a trust can be significantly beneficial to trustees, beneficiaries and most important of all, the settlor, whose original wishes can, once again, be realized.

Adam Katz joined Meltzer Lippe in 2008 and is a member of the Trusts and Estates Group. Adam focuses his practice in all aspects of estate planning and asset protection for both individuals and business entities. Adam also concentrates on charitable planned giving, involving private foundations and tax-exempt organizations. Adam's practice emphasizes strategic tax planning in the areas of trusts and estates, real estate and all types of corporate structures.