Estate Planning

Decanting: Quelling qualms about irrevocability.

By Kristen E. Simmons, Esq.

Advisors often hear the same excuses from clients for not completing an estate plan or implementing life insurance. Sometimes, the client may have already implemented an irrevocable trust and felt that it no longer met their family's needs. This may be a deterrent from using that irrevocable trust or a new trust to acquire life insurance that would provide a significant impact for the client's family. If the client is young, he or she may have concern about changing family circumstances or the fear of missing out on the next great planning opportunity, and the irrevocable nature of various planning techniques may be the roadblock. Decanting is a useful tool to quiet these common client concerns.

What is Decanting?

The term "decant" is defined by Merriam Webster as "to pour out, transfer or unload as if by pouring." In the world of estate planning, decanting is a tool used to modify an irrevocable trust to remove unfavorable provisions, or to make adjustments based on changed circumstances. When an irrevocable trust is decanted, the trustee generally exercises its distribution power over the trust to distribute property from an existing trust to a different trust (whether already existing or newly established) with one or more of the same beneficiaries. Currently twenty-nine states have enacted statutes that permit the decanting of an irrevocable trust. Furthermore, many of the states that have not yet adopted their own decanting statutes are considering the adoption of the Uniform Decanting Act.

Decanting is derived from the Trustee's authority and/or discretion to make distributions of income and/or principal to the beneficiaries of an irrevocable trust. At its core, the theory behind decanting is that if the Trustee has discretion to make a distribution outright to a beneficiary, the Trustee should be able to exercise that discretion to make a distribution to a beneficiary with further strings or conditions (such as in further trust). Each state that has adopted a decanting statute has slightly different requirements in order for an irrevocable trust to be decanted. Under the laws of each state that permits decanting, the common thread is that decanting cannot be used to add a beneficiary that was not a beneficiary of the original trust.

Top 3 Reasons to Decant a Trust

There are several common reasons to decant a trust. Some of these are minor and include changing the situs to alleviate state income tax considerations. The following are what I consider the top three reasons to decant a trust.

1. "EXTEND" THE TERM OF THE TRUST. Many trusts distribute outright to the trust beneficiaries at staggered ages, such as one-third at age 25, half the balance at age 30, and the balance at age 35. The idea behind this outright distribution is to delay the distribution of the assets until a beneficiary's presumed maturity. However, trusts can provide a significant level of creditor, divorce and estate tax savings to the beneficiary if implemented properly.

With trusts that distribute outright at staggered ages, if a beneficiary is being sued or going through a divorce at the time of an outright distribution, the assets may become exposed to claims. Holding assets in a continuing, discretionary trust provides optimal creditor protection. Further, if a beneficiary has developed a problem (for example, drug or alcohol dependency or need for qualification for state benefits), outright distributions can be harmful. Therefore, one of the most common reasons we find to decant a trust is to allow the assets to be held for the beneficiary in continuing trust (rather than distributing outright).

IMPORTANT NOTE: Decanting cannot generally be used to extend the perpetuity period of an existing trust. Doing so may trigger the "Delaware Tax Trap" and therefore have immediate transfer tax consequences.

2. CHANGING A SUPPORT TRUST INTO A DISCRETIONARY TRUST. In certain states, exception creditors can pierce through a support trust – one that distributes to the beneficiaries for their health, education, maintenance and support - and attach the interest of a beneficiary, even if the trust includes a spendthrift clause. A discretionary trust is one in which distributions may be made in the sole and absolute discretion of the trustee, not subject to any specific standard for distribution. A discretionary trust offers a greater level of creditor and divorce protection to the beneficiaries (assuming the use of a proper distribution trustee that is not a beneficiary of the trust), and, with the exception of Florida, the remaining 49 states in the United States recognize the protections offered by a properly drafted discretionary trust. In certain jurisdictions, such as California, state income tax may be applied to a support trust if a beneficiary resides in the state. Because of the added level of creditor protection with a discretionary trust (and potentially state income tax savings), another common reason to decant is to convert a support trust into a discretionary trust. When decanting a support trust into a discretionary trust, situs selection is critical, as only six states expressly permit decanting a support trust into a discretionary trust.

3. ADDING POWERS OF APPOINTMENT. Before decanting, a change in family circumstances or lack of control over an irrevocable trust may have resulted in a full distribution of the trust to the primary beneficiary (thereby negating the transfer tax and creditor protection benefits of the trust). With decanting, instead of distributing the trust to the primary beneficiary, the Trustee may distribute the assets into a trust that gives the primary beneficiary a power of appointment. This power of appointment may be limited so as not to cause inclusion in the beneficiary's estate, but may be broad enough to allow the primary beneficiary to direct the ultimate distribution upon the beneficiary's death (for example, the power of appointment could be exercised by the beneficiary in favor of a person who was not a beneficiary of the original trust).

Although a properly drafted trust can provide divorce and creditor protection to the beneficiaries, if the trust is drafted to be outside the beneficiary's estate for estate tax purposes, then the assets in the trust do not benefit from a step-up in basis, even if the beneficiary does not have a taxable estate. Decanting can be used to transfer assets into a trust that provides a formula general power of appointment. This would purposely include assets in the beneficiary's estate in order to reset the basis of the trust assets (up to the estate tax exemption available in the beneficiary's estate).

Decanting Checklist

Seeing the benefits that can be achieved through decanting, advisors must determine whether an existing trust can be decanted and, if so, whether any changes to the situs of the trust must be made in order to achieve the ultimate goal.

- **Does the trust agreement prohibit decanting?**

  Many older trust agreements do not include a specific prohibition on decanting, since it is a relatively new development in estate planning. However, as clients are implementing estate plans now, we often have clients that have very specific wishes related to their assets and beneficiaries, and do actually want to "rule from the grave." In those client circumstances, it is important to discuss decanting with the clients to determine whether a prohibition should be included in the new trust agreement.

- **Does the trustee have sufficient distribution discretion?**

  In order for the Trustee to exercise the decanting power, the Trustee must have the discretion to make distributions of income and/or principal. In certain trusts, poor drafting may prevent the exercise of the decanting power. For example, many old life insurance trusts do not allow any distributions of income or principal until the death of the settlor/insured. In these trusts, decanting would not be an option while the settlor is alive, and other alternatives would need to be used to potentially move the life insurance policy from the trust.

- **Does the state law of the current situs of the trust allow decanting? Can the situs of the trust be changed? Is the state's decanting law broad enough to achieve the desired changes?**

  A common hurdle to decanting a trust is the trust provision regarding the governing law, situs and/or principal place of administration. If the jurisdiction applicable to the subject trust is one that has not yet adopted a decanting law (or one in which the desired result of decanting cannot be achieved), then the first step is to look to the terms of the trust instrument to see if a change of situs or place of administration is permissible. If it is not permissible under the terms of the trust document, then the advisor must look to the state law of the applicable jurisdiction to see whether it has a decanting law that would allow the change of situs to the desired jurisdiction (resulting in potentially multiple decantings to get to the ultimate resulting trust) or whether the state has adopted some form of the Uniform Trust Code, which allows for either a non-judicial settlement agreement (to modify the trust to allow for a change of situs) or provides a specific statute permitting the change of the principal place of administration of the trust.

Conclusion

In sum, even if a client has a clean slate and has not previously done any estate planning, decanting can be a helpful tool to quell common fears that would impede implementation of the estate plan. For more information on situs selection for decanting, see Steve Oshins' Decanting State Rankings chart, available on our website at www.oshins.com.

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