

TRUSTS & ESTATES

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The Uniform Trust Decanting Act

New opportunities ahead

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Trust decanting is gaining popularity as a flexible and practical technique to modify the provisions of an existing irrevocable trust to respond to changing circumstances that a settlor didn't anticipate. In recognition of this trend, many states have enacted decanting statutes, and several states view decanting as an inherent fiduciary power under the common law. However, challenges often arise when fiduciaries and their advisors must navigate an inconsistent patchwork of state-specific decanting regimes.

The recently promulgated Uniform Trust Decanting Act (the Act) attempts to combine the best parts of the decanting statutes and case law to date and provides a helpful roadmap of the issues to consider when decanting.¹ Whether you're practicing in a common law decanting state or in a state that already has its own decanting statute, the Act provides guidance about what's considered appropriate in any decanting transaction.

In addition, the Act touches on many issues not directly addressed in the existing law, adding new ideas to the decanting discussion. For these reasons, being familiar with the Act will help your practice, wherever you're located.

Decanting Power

Under the existing law of many jurisdictions, the decanting power is encompassed within the trustee's power to make principal distributions. Several states describe the decanting power as a fiduciary power of appointment (POA), whereby a trustee who could make outright distributions instead makes distributions in further trust. Under the Act, however, the power to decant is a conceptually different fiduciary power to modify an

irrevocable trust.

Notwithstanding this theoretical distinction, in practice the Act frames the decanting power by reference to the extent of the trustee's distribution power. As a threshold matter, decanting is permitted under the Act only if a fiduciary has discretion to distribute principal (with a narrow exception for special needs trusts (SNTs)). Thus, income-only trusts and many special purpose estate-planning vehicles that don't allow discretionary principal distributions (such as grantor retained annuity trusts, charitable lead trusts and charitable remainder trusts) can't be decanted under the Act.

Importantly, the Act views decanting as an inherently fiduciary power: Only a fiduciary, subject to fiduciary duties, may decant a trust. As noted in the official comments to the Act, one consequence of this definition is that a distribution advisor who isn't subject to fiduciary duties may not exercise the power to decant. This means, for example, that a directed trust with a distribution advisor who isn't a fiduciary—an increasingly popular trust structure—can't be decanted under the Act.

Scope of Permissible Modifications

Another important tie between the power to make distributions and the power to decant under the Act is the extent to which a decanting can modify the terms of an existing trust. The Act draws a distinction between fiduciaries whose distributive discretion over principal is subject to an ascertainable standard or a reasonably definite standard (called "limited distributive discretion") and fiduciaries with broader distribution authority (called "expanded distributive discretion").

Expanded distributive discretion. A fiduciary with broad discretion to distribute principal is granted a correspondingly expansive power to modify beneficial interests. For example, the new trust can eliminate current and remainder beneficiaries, grant or remove POAs, change the standard for making distributions and eliminate unvested rights, such as a future right to a mandatory distribution on reaching a certain age.

The power to change beneficial interests is subject to important limitations. Similar to many existing state statutes, decanting can't be used to add beneficiaries directly, although a beneficiary may be granted a POA exercisable in favor of someone who isn't a current beneficiary. Furthermore, the new trust can't eliminate vested interests, such as presently exercisable withdrawal rights (including *Crummey* powers).

As one would expect, a fiduciary with expanded distributive discretion may also exercise the power to decant to make administrative changes. For example, an existing trust can be decanted to implement new fiduciary offices (such as distribution and investment advisors, trust protectors and administrative trustees), to change the governing law of the trust and to change trustee powers.

Limited distributive discretion. In contrast, fiduciaries whose discretion to distribute principal is limited by an ascertainable (or similar) standard are granted a much narrower decanting power. Specifically, each beneficiary's interest in the new trust must be substantially similar to the beneficial interests under the existing trust. This means, for example, that a trust that contains an ascertainable standard can't be decanted to remove that standard or to impose additional restrictions on distributions. Only administrative changes will be possible for this type of trust.

Notwithstanding these limitations, the Act would provide substantial flexibility and greater certainty in some common law decanting jurisdictions where it's now unclear whether a trust that restricts the trustees' distributive discretion may be decanted at all.

SNTs. Trusts for beneficiaries with special needs are treated differently from other types of trusts. Under the Act, a fiduciary may decant an existing trust for a beneficiary with a disability to create a qualifying SNT even if the fiduciary has

no discretion to distribute principal.

This special needs decanting power may be exercised only in favor of a trust that isn't counted as an available resource for purposes of determining eligibility for governmental benefits. Under this limited power, all other beneficial interests in the new trust must remain the same as in the existing trust.

Protection of Charitable Interests

The decanting powers described above are subject to limitations designed to protect the interests of charitable beneficiaries. These protections go beyond most existing decanting statutes and should be considered carefully.

For example, if an existing trust contains a charitable interest (other than certain remote charitable interests), the new trust may not diminish that interest, and it may not change the identity of any specific charity that holds that interest.

The Act's charitable protections are intentionally broad and may create a trap for the unwary. The official comments note that a trust that permits discretionary distributions to a named beneficiary during his life with the remainder to charity can't be decanted to give the beneficiary a POA, because the power would diminish the charitable remainder interest.

In this specific example, the prohibition on granting the current beneficiary a POA seems overbroad, because the trustees could eliminate the charitable interest entirely by distributing all of the assets to the current beneficiary. States that consider adopting the Act should think about narrowing the scope of these charitable protections.

The Act also contains procedural safeguards intended to ensure meaningful oversight of charitable interests by the Attorney General. Specifically, if a trust contains a determinable charitable interest—essentially, a right to a mandatory distribution not subject to any conditions or trustee discretion—the Attorney General may represent the holders of that charitable interest in the decanting.

Importantly, the Act doesn't permit the decanting of wholly charitable trusts, such as private foundations organized in trust form. An established body of law governs the reformation of

charitable trusts, and the Act isn't intended to override those rules.

Choice of Law

The Act is intended to have very broad applicability to avoid difficult choice-of-law questions regarding which state's laws govern the trust and the exercise of the trustee's decanting power.

The Act will be available to any trust with a principal place of administration in a state that's enacted it. The Act will also apply to any trust whose instrument provides that it's governed by the laws of the enacting state, either generally or for the specific purpose of administration, construction or determining the meaning or effect of the trust's terms. This provision avoids the need for determining whether the exercise of the decanting power in each particular case is primarily administrative or dispositive in nature.

The Act doesn't override any other decanting mechanisms that may apply to a trust (such as common law, the statutes of another jurisdiction or specific provisions in the instrument). As a result, fiduciaries in a state that's adopted the Act could have many options for decanting.

Fiduciary Limitations on Decanting

Consistent with many existing decanting statutes and case law, the Act gives fiduciaries the power to decant, but doesn't create or imply a duty to decant. Nevertheless, if a fiduciary decides to exercise the decanting power, the decanting must comply with fiduciary principles.

To that end, the Act places several express restrictions on the exercise of the decanting power to mitigate potential self-dealing concerns. These statutory limitations aren't exclusive, and fiduciaries will need to evaluate the appropriateness of each decanting on the basis of all relevant facts and circumstances.

- **Trustee compensation:** The new trust may not increase the compensation of any fiduciary participating in the decanting above the amounts stated in the instrument or permitted under applicable law, unless all qualified beneficiaries of the new trust consent or a court approves the increase. But, a merely incidental increase in compensation—for example, because the property will remain in trust longer or because distributions will

be reduced—doesn't require consent.

- **Trustee liability:** The new trust may not reduce the fiduciary's liability for breach of trust or indemnify the fiduciary to a greater extent. Similarly, a decanting may not reduce fiduciary liability in the aggregate, but may divide and reallocate fiduciary powers among multiple fiduciary offices.

- **Trustee removal:** The new trust may not modify the provisions for removing fiduciaries, with several very narrow exceptions that require either beneficiary or court approval.

Most of these concepts fit neatly within the familiar fiduciary duty of loyalty, but the Act's very restrictive provisions governing changes to trustee removal powers may come as a surprise to practitioners. Because there are often good reasons to modify existing trustee removal powers, states that consider adopting the Act may want to broaden these provisions.

Protections for Fiduciaries

The Act includes several novel provisions designed to provide greater protection and comfort to fiduciaries of decanted trusts.

First, a decanting that doesn't fully comply with the requirements of the Act is automatically reformed to make the attempted decanting valid. For example, if the new trust inadvertently omitted a required provision, that provision is deemed to have been included in the governing instrument of the new trust from the outset.

Second, the Act expressly waives liability for any person who reasonably relies on the validity of a prior decanting. This provision frees fiduciaries from the obligation to investigate the specific details of a prior decanting affecting the trust, which may be difficult or impossible, especially if the decanting was subject to the laws of another jurisdiction.

Tax Issues

At present, the tax consequences of trust decanting are unclear. In the absence of definitive guidance from the Internal Revenue Service, the Act includes broad tax savings language intended to ensure that the decanting power doesn't jeopardize any tax benefits associated with an existing trust.

The Act generally requires a new trust to include any provision necessary to qualify the new trust

for an existing tax benefit; likewise, the new trust may not include any disqualifying or impermissible provision. This tax savings language works together with the automatic correction mechanism described above and effectively reads any required tax provision into the new trust.

In addition, the Act includes specific provisions for protecting common tax benefits, including the marital deduction, charitable deduction, gift tax annual exclusion (including Internal Revenue Code Section 2503(c) trusts) and the generation-skipping transfer tax annual exclusion. Protection is also available for: (1) trusts that own S corporation shares or retirement plan assets, (2) trusts that are treated as foreign grantor trusts under the special rules of IRC Section 672(f)(2)(A), and (3) any other tax benefits for which an existing trust may have qualified.

These provisions are particularly interesting for trusts that were previously considered difficult to decant, such as qualified terminable interest property (QTIP) trusts. The official comments express the common concern that if a QTIP trust could be decanted to eliminate the surviving spouse's income interest, the QTIP election would be invalid from inception, a disastrous result. The Act's tax savings language is intended to eliminate this possibility.

The Act confirms that decanting may be used to toggle the grantor trust status of an existing trust for income tax purposes. Interestingly, however, the Act allows the settlor to prevent the trustees from decanting an existing trust to a new grantor trust that would limit the settlor's ability to turn grantor trust status off, on the theory that no settlor should be forced to bear the trust's income tax liability against his will. This veto power shouldn't cause the trust assets to be included in the settlor's taxable estate, just as holding the power to turn off grantor trust status doesn't cause inclusion.

Decanting Formalities

Decanting under the Act must comply with several procedural formalities.

First, the fiduciary is required to give written notice of the proposed exercise of the decanting power to a broad class of recipients, including: (1) the settlor, (2) each qualified beneficiary, (3) each holder of a presently exercisable POA over the existing trust, (4) each fiduciary of the existing

trust, (5) each person who has the right to remove and replace the current fiduciaries, and (6) each fiduciary of the new trust. If the existing trust includes a charitable interest, the fiduciary must also give notice to the Attorney General.

The notice must describe the manner in which the decanting power will be exercised, specify the proposed effective date and include copies of both the existing trust and the new trust. The Act notes that it may also be appropriate to provide a description of the specific modifications being made.

Second, there must be a written instrument memorializing the decanting. This document must identify all of the trusts involved in the decanting, as well as the specific assets being distributed to the new trust or remaining in the existing trust.

Third, unlike many existing decanting statutes and case law, an actual distribution from the existing trust to a new trust isn't required. This is because the Act views the decanting power as a power to amend the governing instrument. As a result, a trust can be decanted simply by amending one or more specific provisions or by a complete restatement. An amendment will often be preferable from a practical perspective, because it avoids the need for retitling trust assets, obtaining a new taxpayer identification number and filing a final tax return.

Alternatively, the decanting can be structured as a complete or partial distribution of assets to a new trust. The new trust can be created in connection with the decanting, or it can be another existing trust created by the same or different settlor.

An Important Milestone

The Act represents an important milestone in the rapidly developing field of trust decanting. It's a comprehensive statutory regime that gives much needed guidance to trustees and their advisors in this emerging area. States should consider adopting the Act to give fiduciaries greater flexibility and certainty in administering trusts and to make their jurisdictions more attractive to trust business.

Endnote

1. The full text of the Uniform Trust Decanting Act is available online at www.uniformlaws.org/Act.aspx?title=Trust%20Decanting.