COMMON-LAW DECANTING

Common-Law Decanting of Trusts: Lessons From Massachusetts

A court decision empowering trustees to decant trust assets even in states without decanting legislation raises questions as well as planning options.

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In a recent case, *Ferri v. Powell-Ferri*,[1] the Supreme Judicial Court (SJC) of Massachusetts held that the trustees of an irrevocable trust had the fiduciary power to distribute the trust assets to a new trust—to “decant”—even though Massachusetts has no decanting statute.

At first glance, this ruling simply appears to reaffirm the court's 2013 holding in *Morse v. Kraft.*[2] That case held for the first time that there is, and always has been, a common-law

decanting power in Massachusetts. A more careful analysis of the *Ferri* opinion, however, reveals many unanswered and troubling issues associated with the court's decision.

This article describes some of the key challenges of common-law trust decanting highlighted by *Ferri.* It focuses on technical issues and practical considerations to keep in mind when decanting under the common law (as in Massachusetts) or under a statute, especially if a statute is silent on important questions, such as the treatment of presently exercisable withdrawal rights.

Facts of the case

The Massachusetts high court's ruling on trust decanting arose out of a highly contentious divorce proceeding in Connecticut. As part of that litigation, the Connecticut Supreme Court certified three questions of Massachusetts trust law to the SJC, and the court's opinion was limited to answering those specific questions. This unusual procedural posture and the complicated facts of the underlying Connecticut divorce proceedings are critical to understanding the SJC's analysis.

Family dynamics. The trust at issue was created by Paul John Ferri, Sr., a successful venture capitalist in the Boston area. In 1983, Paul, Sr. established a Massachusetts irrevocable trust for the benefit of one of his three children, Paul John Ferri, Jr., who at that time was 18 years of age.

Paul, Jr. began his career working at his father's investment firm. Shortly thereafter, he decided to go into business with his brother Michael. Their business grew significantly over time, with financial backing from several Ferri family trusts.

In 1992, Paul, Jr. met Nancy Powell at a college reunion. They got married in 1995, and had three children together. Nancy was a social worker at a Boston hospital, and left work after the birth of their first child.

In October 2010, after 15 years of marriage, Nancy filed a divorce petition in the Connecticut Superior Court. The protracted legal proceedings that followed were

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marked by bitterness and family strife—as well as millions of dollars in legal fees.

The 1983 trust. Paul, Jr.'s 1983 trust was at the center of the divorce action. The trust had been a source of tension between the spouses during marriage, in part because distributions

from the trust were relatively modest. The family lived primarily on Paul, Jr.'s business income, and trust funds were used only for specific expenses, such as home improvements.

Paul, Jr.'s desire to keep most of the assets invested within the trust paid off handsomely. By 2014, the trust had grown in value to nearly $90 million.

The trust's investment portfolio consisted of interests in several of Paul, Sr.'s investment funds, hedge funds, publicly traded securities, and cash. In addition, the 1983 trust was a significant investor in Paul, Jr.'s business ventures.

At the heart of the dispute between the spouses were the dispositive provisions of the trust. The 1983 trust benefitted solely Paul, Jr., with a two-tier structure for making funds available to him. These provisions played a critical role in the SJC's decanting analysis.

First, during Paul, Jr.'s lifetime the trustees had broad discretion to “pay to or segregate irrevocably for later payment” to him any portion of the trust's funds. The trust instrument also provided that any assets distributable to Paul, Jr. could instead be applied for his benefit.

Second, the 1983 trust instrument granted Paul, Jr. the right to withdraw a percentage of the trust's assets upon reaching specific age thresholds. At the time of the decanting (described below), Paul, Jr. could withdraw three-fourths of the value of the trust's assets determined as of his 43rd birthday. By the age of 47, Paul Jr. could withdraw the entirety of the trust's assets.

The 1983 trust also granted Paul, Jr. a testamentary limited power of appointment exercisable in favor of his father's issue, as well as Paul, Jr.'s spouse. This provision was not intended to benefit Nancy specifically, because the 1983 trust had been created several years before the couple met in 1992.

Another relevant feature of the 1983 trust instrument was a spendthrift provision, which prohibited Paul, Jr. from assigning or alienating his interest in the trust.

The decanting. Several months after Nancy filed for divorce, the trustees of the 1983 trust—who were Paul, Jr.'s brother Michael and his father's attorney—transferred virtually all of the assets of the 1983 trust to a new 2011 trust.[3] The trustees claimed that the 1983 trust was “under attack” by Nancy, and they decanted the trust in order to shield its substantial assets from her claims in the divorce.

Importantly, the trustees did not notify Paul, Jr. before implementing the decanting. The Connecticut Superior Court specifically found that Paul, Jr. did not consent to the decanting and was not involved in it in any way.

At the time of the decanting, Paul, Jr. was 46 years old. In accordance with the dispositive provisions of the 1983 trust, he held a vested, presently exercisable right to withdraw up to 75% of the 1983 trust assets. After the decanting and during the pendency of the Connecticut divorce proceedings, Paul, Jr. reached age 47, which meant he could withdraw the entirety of the 1983 trust assets.

The 2011 trust instrument was significantly different from the 1983 trust. Most notably, the 2011 trust eliminated Paul, Jr.'s presently exercisable withdrawal rights over 75% (and later 100%) of the trust property. In addition, the 2011 trust instrument granted Paul, Jr. a new inter vivos limited power of appointment and an expanded testamentary limited power of appointment.

The inter vivos power of appointment could be exercised only for the benefit of Paul, Jr.'s descendants. As discussed below, this power of appointment almost certainly was granted for tax reasons, and was not intended to be actually exercised during his life.

The testamentary power of appointment in the 2011 trust could be exercised in favor of any person, excluding, however, Paul, Jr., his estate, his creditors, and the creditors of his estate—and also specifically excluding Nancy. The 2011 trust instrument also contained a spendthrift clause, similar in scope to the spendthrift provision in the 1983 trust. Unlike the 1983 trust, the 2011 trust was governed by Connecticut law.

Summary of Connecticut proceedings. The Connecticut divorce proceedings that led to the

Massachusetts high court's decision were lengthy and complicated.

Several months after the 1983 trust was decanted, the trustees of the 1983 trust and the 2011 trust filed a declaratory judgment action in the Connecticut Superior Court. That action sought confirmation that the decanting was valid and that Nancy had no claim to the assets that had been transferred to the 2011 trust.

As part of that action, the trustees submitted an affidavit from Paul, Sr. The affidavit stated that the settlor of the 1983 trust had intended to give the trustees the specific authority to do anything that was necessary and in the best interests of the beneficiary, including the authority to protect the trust assets if they were at risk, such as in the event of a lawsuit or divorce.

Notably, the affidavit stopped short of expressly confirming that the settlor had intended to authorize the trustees to decant. Instead, the affidavit merely stated that the trustees had the power to “irrevocably set aside” any part of the trust assets (mirroring the language in the trust instrument) if they determined that doing so would be in Paul, Jr.'s best interests.

The proceedings in the superior court went in Nancy's favor. The judge struck the affidavit and ordered restoration of 75% of the trust assets from the 2011 trust to the 1983 trust, an accounting of the 2011 trust, and an award of reasonable attorney's fees to Nancy.

The parties appealed the trial judge's order, and the appeals were transferred to the Connecticut Supreme Court.

SJC's ruling and analysis

The Connecticut Supreme Court certified three questions of Massachusetts trust law to the SJC of Massachusetts:

(1) Under Massachusetts law, did the terms of the 1983 trust empower its trustees to decant the trust?

(2) If the answer to question 1 is “no,” should either 75% or 100% of the assets of the 2011 trust be returned to the 1983 trust?

(3) Under Massachusetts law, should a court consider the settlor's affidavit in interpreting whether Paul, Sr. intended to permit decanting to another trust?

The SJC answered the first and third questions in the affirmative. Consequently, the court did not need to reach the second question.

Power to decant. The SJC's analysis began with a reaffirmation of the holding and reasoning of the *Kraft* case. The court reiterated that a trustee of a Massachusetts irrevocable trust may be granted the power to decant through language in the governing instrument, even where there is no decanting statute.

What is more, the decanting authority need not be granted expressly, and may be inferred from the entirety of the powers given to the trustee by the settlor. As always, the settlor's intent in this regard is paramount.

The SJC proceeded to examine the specific language of the 1983 trust instrument and concluded that it demonstrated Paul, Sr.'s intent to permit decanting. The court's decision was based on the “extremely broad authority and discretion” granted to the trustees, together with the two-tier distribution structure described above, the spendthrift clause intended to protect the trust assets, and the settlor's affidavit.

In reaching this conclusion, the SJC focused on three specific aspects

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of the 1983 trust instrument, namely the power to "segregate irrevocably for later payment" to the beneficiary any portion of the trust assets; the power to apply distributions for Paul, Jr.'s benefit; and the grant of specific authority to care for, manage, and dispose of the trust property without order or license of the court.

The court emphasized that no particular language is necessary or required, and the relevant inquiry is whether the settlor intended to authorize the trustees to decant the trust. Nevertheless, the court pointed to the apparent close similarity between the provisions of the 1983 trust instrument and the language of the trust at issue in *Kraft*, concluding that the 1983 trust contained ample evidence of the settlor's intent to authorize decanting.

The court disagreed with Nancy's arguments that two other provisions of the 1983 trust instrument limited the trustees' ability to decant.

First, the SJC held that the spendthrift provision in the 1983 trust was consistent with the trustees' decanting power. This conclusion followed from the fact that the spendthrift clause was plainly intended to protect the trust assets from Paul, Jr.'s creditors, and the authority to decant served as a means of accomplishing that goal.

Second, the SJC held that Paul, Jr.'s withdrawal rights over the trust assets did not curtail the trustees' decanting power. Contrary to Nancy's arguments, the court concluded that to hold otherwise would mean that the trustees had no control over the trust's assets and no continuing role with respect to the trust after Paul, Jr. turned 47—a plainly incorrect result.

In reaching this conclusion, the SJC pointed to long-standing Massachusetts case law confirming that a trustee holds full legal title to the trust assets, which meant that the trustees of the 1983 trust had "authority and stewardship" over all assets that had not been actually withdrawn by Paul, Jr. The court drew an analogy to a terminating trust, where it is undisputed that the trustees have ongoing duties and powers over the remaining trust property notwithstanding the beneficiaries' vested right to receive the assets.

Finally, the SJC construed the dispositive provisions of the 1983 trust instrument as creating a coordinated structure for making assets available to the beneficiary. That is, Paul, Jr.'s right to withdraw the specified percentages of the trust property extended only to those assets that had not been previously distributed to him in the exercise of the trustees' distributive powers *and* had not been segregated for later payment, through a decanting or otherwise.

Settlor's affidavit. The SJC concluded that the Connecticut courts should consider the settlor's affidavit in ascertaining whether he had intended to permit the trustees to decant the 1983 trust. Importantly, the SJC determined that there was an ambiguity concerning the settlor's intent when examining only the trust language, because it neither permitted nor

barred decanting. For that reason, extrinsic evidence in the form of Paul, Sr.'s affidavit could be considered.

This holding is consistent with the SJC's earlier decision in *Kraft*, which similarly permitted the parties to introduce an affidavit from the settlor as evidence of his intent. As noted above, the *Kraft* affidavit was even more specific, and stated that the settlor had expressly intended to authorize the trustees to decant the trust. The *Ferri* case suggests that a less specific affidavit can still be helpful to support a decanting.

Challenges ahead

The SJC's decision in *Ferri* raises many difficult questions for practitioners in common-law decanting states like Massachusetts, as well as for practitioners in states with less robust decanting statutes that do not, for example, specifically address the treatment of presently exercisable withdrawal rights.[4]

Is there a duty to decant? At the very end of its analysis of the first certified question—whether the terms of the 1983 trust *empowered* its trustees to decant the trust—the SJC stated that, in accordance with the dispositive provisions of the trust instrument, “the trustee could exercise his or her powers and obligations under the 1983 Trust, including the *duty* to decant if the trustee deemed decanting to be in the beneficiary's best interest” (emphasis added).

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This reference to an affirmative duty to decant is troubling, and will undoubtedly come as an unwelcome surprise to many fiduciaries and their advisors, both in Massachusetts and nationwide. Unfortunately, the SJC's decision may leave fiduciaries open to new challenges by disgruntled beneficiaries, who could argue that trustees have a duty to decant in order to produce terms more favorable to those beneficiaries.

Without question, the reference to a potential duty to decant in the SJC's opinion is mere dictum. It goes beyond the narrow question certified to the SJC, namely whether the trustees had the *power*—not the *duty*—to decant the 1983 trust. Furthermore, the opinion offers no explanation for this statement and no discussion of what the extent of this duty might be.

Yet this aspect of the SJC's ruling highlights one of several important distinctions between common-law and statutory decanting. Many decanting statutes contain an express disclaimer that they do not create an affirmative duty to decant.[5] The same is true of the recently promulgated Uniform Trust Decanting Act.[6] The *Ferri* case appears to take a diametrically opposed approach.

In deciding both of its decanting cases—*Kraft* and *Ferri*—the Massachusetts high court called on the Massachusetts legislature to consider enacting decanting legislation. It may be that the specter of an affirmative obligation to decant will finally mobilize practitioners and lawmakers in Massachusetts, as well as in other states, to heed that call.

Decanting and public policy. Another challenging question raised by the *Ferri* case concerns the interplay between trust decanting and public policy.

In *Ferri*, the chief justice of the SJC wrote a separate concurring opinion to emphasize that the court's decision was limited to the three certified questions. As such, it did not consider an important separate issue, whether Massachusetts law would permit a trust to be decanted for the express purpose of shielding the trust assets from claims of the beneficiary's spouse in a divorce.

Such a decanting would plainly raise significant public policy concerns, and the concurrence urged the Massachusetts legislature to consider these issues in crafting a decanting statute. In the absence of further guidance, however, the permissible boundaries of common-law decanting in situations that implicate favored types of creditors (such as spouses) remain unclear.

Common law or statute? As noted above, the decanting framework in *Ferri* and *Kraft* is conceptually rooted in the power to make distributions to or for the benefit of the beneficiary. In enacting a

decanting statute after the *Ferri* decision, therefore, legislatures will need to determine whether the statute should serve as the exclusive means for decanting a trust, or whether common-law decanting should remain a separate, viable option.

Examples from several other states provide relevant guidance. Decanting statutes in New York and Florida make it clear that they are not intended to abridge the power to decant that may arise under common law or otherwise.[7] The Uniform Trust Decanting Act adopts the same approach.[8]

In practice, the ability to decant outside of the parameters of a decanting statute can provide practitioners with much-needed additional flexibility. In light of the many unanswered questions associated with common law decanting, however, states that enact decanting statutes after the *Ferri* decision should consider addressing the interplay between common-law and statutory decanting more explicitly.

Tax considerations

Trust decanting involves many complicated tax issues, with few definitive answers to date.[9] The SJC's opinion in *Ferri* makes no mention of any tax issues at all, likely because the questions certified to the court were confined to matters of trust law. Nevertheless, the SJC's holding that the power to decant may be exercised to eliminate a presently exercisable right of withdrawal could have far-reaching—and unintended—tax consequences.

***Crummey* rights.** One troubling consequence of the *Ferri* decision relates to *Crummey* rights, where a beneficiary is granted the power to withdraw a portion of the trust assets in order to qualify contributions to the trust as gifts of a "present interest" for purposes of the gift tax annual exclusion.[10]

If a power to decant could be exercised to eliminate a presently exercisable withdrawal right—as it was in *Ferri*—might the IRS argue that the mere existence of the decanting power, whether or not it is actually exercised, defeats the beneficiary's *Crummey* rights, thereby preventing contributions to the trust from qualifying for the gift tax annual exclusion? Many decanting statutes and the Uniform Trust Decanting Act specifically address this issue, and prohibit decanting if it would reduce or eliminate a presently exercisable withdrawal power.[11]

This is another point, therefore, on which the *Ferri* decision is contrary to the existing body of decanting law, because it explicitly subordinates the beneficiary's withdrawal right to the trustees' power to decant. Many statutes that address this question have taken the opposite approach.

Gift tax concerns. For gift (and estate) tax purposes, a presently exercisable withdrawal power is treated as a general power of appointment.[12] If a trust is decanted to eliminate this power, there is a concern that the beneficiary has made a taxable gift to the trust by reason of a lapse or release of the general power of appointment (subject to the "5-and-5" limitation).[13]

In *Ferri*, the trustees addressed this concern by granting the beneficiary an inter vivos limited power of appointment over the decanted 2011 trust in favor of his descendants, which made the potential gift incomplete.[14] Practitioners should note that any beneficiary holding such a power should be careful not to actually exercise it, because doing so would make the gift complete at that time.

A similar issue arises in the context of decanting a trust with multiple beneficiaries. If one of the beneficiaries holds a presently exercisable withdrawal power which is then eliminated, the trustees should not make distributions to any other beneficiary after decanting the trust. This is because such distributions would also be treated as completed gifts by the former powerholder-beneficiary to the recipient of the distribution.

Estate tax concerns. If a beneficiary dies holding a withdrawal power, the property subject to that power will be included in the beneficiary's estate for estate tax purposes (also subject to the "5-and-5" limitation). But what is the consequence if a trust is decanted to eliminate this withdrawal power?

Even if the new trust is structured to avoid an immediate taxable gift (as was the case in *Ferri*), the IRS may still argue that the decanted trust should be included in the beneficiary's estate, on the theory that the decanting effected a lapse or release of a general power of appointment. Under this argument, the former-powerholder beneficiary would be treated as the settlor to the extent of the release, effectively creating a self-settled trust.[15]

Interestingly, in *Ferri*, the 2011 trust instrument included language stating that no part of the trust assets would be included in the beneficiary's estate on his death. If this language was intentional, it suggests that the trustees and the beneficiary intend to take the position that the decanting did not result in a taxable lapse or release of Paul, Jr.'s general power of appointment. Perhaps the argument is that a taxable lapse or release requires some affirmative action by the beneficiary, whereas Paul, Jr. did not participate in the 2011 decanting in any way. Whether this argument will convince the IRS is unclear.

Even if the IRS disagrees with the trustees' theory, however, the 2011 decanting should not make the beneficiary any worse off from an estate tax perspective. This is because without the decanting, the 1983 trust assets, the entirety of which could be withdrawn by Paul, Jr. by the end of the litigation, certainly would have been included in his estate at death.

GST tax concerns. The generation-skipping transfer (GST) tax considerations of trust decanting are especially complicated. Most practitioners know that a GST exempt or "grandfathered" trust must be decanted in compliance with the four safe harbors contained in the GST "effective date" regulations.[16] It appears that the *Ferri* decanting, like the decanting in *Kraft*, was structured to satisfy the first of these safe harbors—as a decanting authorized by the terms of the original 1983 trust instrument and Massachusetts common law that did not extend the perpetuities period in the original trust.

Although the GST tax status of the 1983 trust is not discussed in the SJC opinion, some basic facts can be inferred. The 1983 trust was created before the effective date of the GST tax. According to a trustees' receipt attached to the 1983 trust instrument, the trust was initially funded in July 1983, also before the effective date of the GST tax. If the trust did not receive any additional contributions after the GST tax came into effect in 1985, then it would be entirely grandfathered for GST tax purposes.[17]

A relevant question is whether the decanting into the 2011 trust resulted in a lapse or release of a general power of appointment, as discussed above. If so, the decanting would be treated for GST tax purposes as a constructive addition to the "grandfathered" portion of the trust, jeopardizing the trust's GST tax-favored status.[18] Furthermore, the decanting would result in a change in the identity of the transferor for GST tax purposes (from Paul, Sr. to Paul, Jr.), either at the time of the decanting or on the beneficiary's later death.[19]

Interestingly, the 2011 trust instrument contained a statement that the decanted trust's inclusion ratio for GST tax purposes was zero, and that no part of the 2011 trust assets would be subject to GST tax. Yet if there was a constructive addition as described above, this statement may not be correct.

Income tax concerns. The *Ferri* decanting raises a final tax issue,

being the income tax status of the decanted 2011 trust. Assuming that a trust is not otherwise treated as a grantor trust with respect to the trust settlor, the existence of a presently exercisable withdrawal power over a portion of the trust assets causes the powerholder-beneficiary to be treated as the owner of that portion of the trust for income tax purposes.[20]

Under the tax code, if the beneficiary holding the withdrawal power partially releases or modifies that power, grantor trust status as to the beneficiary continues after such release or modification.[21] Whether this provision of the tax code applies to a *complete* release of the power is unclear. Likewise, it is unclear whether some affirmative action by the beneficiary holding the withdrawal power is required. Given these uncertainties, practitioners will need to exercise judgment in determining the income tax status of a decanted trust that eliminated a beneficiary's withdrawal power.

Conclusion

The *Ferri* case reaffirms that common-law decanting continues to be a helpful planning technique. One decidedly positive aspect of the *Ferri* decision is the comfort it gives to trustees seeking to eliminate withdrawal powers, or mandatory distributions, before the triggering ages arise. If the decanting in *Ferri* is possible, certainly the lesser decanting to change the trust terms before the relevant date occurs must also be possible.[22]

In addition, it suggests that a settlor's supporting affidavit need not specifically refer to decanting, but may state simply that the settlor intended the trustees to undertake any actions in the beneficiaries' interest. This more general form of affidavit will be much easier for most living settlors to sign.

Notwithstanding these helpful aspects, the *Ferri* case is most significant for the unresolved public policy and tax issues it raises, which serve as a reminder that decanting, particularly under the common law, is rife with traps for the unwary. The suggestion—in dictum but nevertheless present—that there may be an affirmative duty to decant calls particular attention to the need for decanting statutes to address these myriad questions.

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[1] 476 Mass. 651 (2017).

[2] 466 Mass. 92 (2013).

[3] It appears that the trustees of the 1983 trust retained $5,000 in cash, presumably to keep the trust in existence during the pendency of the court proceedings.

[4] See, e.g., Fla. Stat. §736.04117; R.I. Gen. Laws §18-4-31.

[5] See, e.g., Del. Code Ann. tit. 12, §3528(e) ("No trustee or adviser shall have a duty to exercise [the authority to decant] nor, absent wilful misconduct, any liability to any person for failure to exercise such authority or failure to consider whether to exercise such authority."); N.H. Rev. Stat. Ann. §564-B:4-418(o) ("A trustee does not have a duty to decant or an ongoing duty to consider whether to decant.").

[6] Uniform Trust Decanting Act, §4(b) ("This [act] does not create or imply a duty to exercise the decanting power or to inform beneficiaries about the applicability of this [act].").

[7] N.Y. Est. Powers & Trusts Law §10-6.6(k); Fla. Stat. §736.04117(7).

[8] Uniform Trust Decanting Act, §3(d).

[9] See IRS Notice 2011-101, 2011-52 IRB 932 (soliciting comments on the tax treatment of trust decanting) and numerous comments submitted in response to that Notice.

[10] See IRC Section 2503(b).

[11] See, e.g., Del. Code Ann. tit. 12, §3528(a)(4) (decanting power does not apply to trust property subject to a presently exercisable power of withdrawal held by a sole trust beneficiary); N.H. Rev. Stat. Ann. §564-B:4-418(g); Uniform Trust Decanting Act, §11(c)(3) and § 19(b)(3).

[12] Section 2041(b) (estate tax definition); Section 2514(c) (gift tax definition).

[13] See Sections 2514(b) and (e).

[14] Reg. 25.2514-3(c)(1).

[15] Reg. 20.2041-3(d)(1).

[16] See Reg. 26.2601-1(b)(4).

[17] See generally Reg. 26.2601-1.

[18] See Reg. 26.2601-1(b)(1)(v)(A).

[19] See Reg. 26.2652-1, especially Reg. 26.2652-1(a)(5), Example 5.

[20] Section 678.

[21] Section 678(a)(2).

[22] Note that most of the tax concerns described above should not be implicated in such a decanting, with the exception of the GST tax issues.

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