HOW TO MODIFY AN IRREVOCABLE TRUST UNDER DELAWARE LAW

Presented to
Delaware Trust Camp
October 27, 2014
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of the beneficiaries of the first trust. Although the concept behind the decanting statute is fairly simple, its implications are immense.

Decanting statutes can be used to update the terms of a governing instrument by pouring over all of the assets from a trust governed by an outdated instrument to a new trust that contains modern administrative provisions that will afford more flexibility to the trustee and beneficiaries. The decanting statute can also be used in certain situations to alter the beneficial interests in a trust.

A. Requirements for Use of Decanting Statute.

The various statutes all have different requirements that must be satisfied in order for a trustee to be able to avail itself of the benefit of the state's statute. However, there are common themes which run throughout the majority of the state's statute.

1. Principal Invasion Right.

As a starting point, the trustee of the first trust must have the ability to invade principal for the benefit of one or more of the beneficiaries of the trust. The various states differ in their requirements with respect to the principal invasion right. For instance, Delaware, Alaska, New York and Tennessee permit a trustee that has the authority to invade principal to decant the assets into a new trust even if the principal invasion power is limited by a standard. Florida and Indiana on the other hand require the trustee to have an absolute power to invade principal which is not limited pursuant to an ascertainable standard.

South Dakota appears to have the only decanting statute which does not require that a trustee have some principal invasion right in order to utilize the statute. Under South Dakota law, a trustee can decant income from one trust to another. S.D. CODIFIED LAWS § 55-2-15. The South Dakota statute therefore expressly authorizes distribution of income from one trust to another trust.

Delaware's decanting statute provides that the trustee's exercise of the decanting power must comply with any standard imposed by the first trust. 12 Del. C. § 3528(a)(5). For example, if the first trust provides that the trustee may only distribute trust principal to the beneficiaries for their health, education, maintenance and support, the second trust must limit distributions to the beneficiaries only for their health, education, maintenance and support. Delaware's statute would allow the second trust to further restrict the purposes for which distributions could be made, but the distribution standard may not be broadened. For example, the second trust could provide that distributions shall only be made to the beneficiaries for their education, but it could

not allow distributions to be made for any purpose not related to the standard contained in the first trust.

2. **Permissible Beneficiaries.**

The state decanting statutes impose limitations on a trustee's ability to exercise the decanting power. All of the statutes require that the trustee's exercise of the decanting power be in favor of one or more of the beneficiaries of the first trust. As such, the decanting statute cannot be used to add beneficiaries to the second trust that are not beneficiaries of the existing trust.

In certain states the decanting statute may be used to eliminate beneficiaries of the existing trust. For instance, assume trust one provides that the trustee can distribute trust principal to A, B and C in its sole and absolute discretion. The trustee may be able to utilize its decanting power to distribute the trust assets to trust two which only benefits B and C. This provision may be beneficial if a trustee desires to divide a pot trust into separate trusts for the beneficiaries of the first trust.

Some state decanting statutes permit the new trust to grant beneficiaries of the existing trust powers of appointment not otherwise set forth in the original trust. For instance, both Delaware and Nevada permit the new trust instrument to grant a beneficiary of the existing trust a general or limited power of appointment, thereby allowing the decanting to indirectly add beneficiaries to the first trust by granting beneficiaries of the second trust powers of appointment not otherwise contained in the first trust. This seems consistent with the basic concept behind decanting which is that if the trustee could distribute trust assets outright to the beneficiary, the trustee should be able to exercise such principal invasion power by distributing the assets in further trust which such further trust grants the beneficiary a power of disposition over the trust assets.

3. **Elimination of Beneficiaries' Rights in Trust.**

Some state decanting statutes prohibit the decanting from eliminating certain rights a beneficiary may have over the trust. For instance, New York, Alaska and Tennessee prohibit the decanting power from reducing any fixed income interest a beneficiary may have in the trust. Under Delaware law, the decanting power may not be used to eliminate a fixed income right with respect to a trust that qualifies for the marital deduction. 12 Del. C. § 3528(a)(5).

Delaware's decanting statute can be used to eliminate a fixed income right with respect to a trust that does not qualify for the marital deduction. For instance, assume the terms of trust one provide that all of the income is to be distributed to A during her lifetime and also gives the trustee the ability to distribute principal to A for her health, education, maintenance and support.

Under Delaware's decanting statute, the trustee could decant all of the assets of trust one to trust two which eliminate A's mandatory income interest in the trust and instead allows the trustee to distribute income and principal to A in its sole and absolute discretion for her health, education, maintenance and support.

Another issue that often arises in a decanting is whether the decanting can eliminate a beneficiary's right of withdrawal over the trust property. Some states, such as North Carolina, provide that if a beneficiary has a power of withdrawal over trust property in trust one, the terms of trust two must provide the beneficiary with an identical right of withdrawal or sufficient property must remain in trust one to satisfy the outstanding power of withdrawal. N.C. Gen. Stat. § 36C-8-816.1.

Other states, such as Delaware, permit a decanting to eliminate a beneficiary's right of withdrawal over trust property as long as the right of withdrawal is not presently exercisable. 12 Del. C. § 3528(a)(4). For example, assume the terms of the first trust provide that the trustee may distribute income and principal of the trust to or for the benefit of A in its sole and absolute discretion and that upon attaining the age of thirty-five (35), A shall have the ability to withdraw all of the trust assets. As long as A has not attained the age of thirty-five (35) prior to the decanting, the decanting statute of certain states would permit trust two to eliminate A's right to withdraw the assets upon attaining the age of thirty-five (35).

4. **Notification to Beneficiaries.**

Most of the decanting statutes provide that the authority to decant is in the sole and absolute discretion of the trustee and that it is not necessary to obtain beneficiary consent in order for a trustee to exercise its decanting power. Some states such as Arizona, Nevada, New York and North Carolina permit a trustee to seek judicial approval for a decanting.

5. **Governing Law Considerations.**

Another issue that often arises in a decanting relates to whether the law of the particular jurisdiction must govern the first trust in order for the trustee to avail itself of the benefits of that particular jurisdiction's decanting statute. For instance, assume that trust one provides that Kansas law governs the validity, construction and administration of the trust and there is no mechanism contained in the trust instrument to transfer the situs of the trust or otherwise change the administrative laws governing the administration of the trust. Is it possible for a trustee to be appointed in another jurisdiction that has a decanting statute, such as New York, transfer all of the assets to the New York trustee and then have the New York trustee decant the trust assets

under New York's decanting statute notwithstanding the fact that Kansas law continues to govern the validity, construction and administration of trust one?

Several state decanting statutes provide that the use of the statute to decant shall be considered the exercise of a limited power of appointment. For instance, Delaware's statute specifically states that the trustee's decanting power shall be considered the exercise of a limited power of appointment. 12 Del. C. § 3528(c).

Many states make it clear that the validity of the exercise of a limited power of appointment is governed by the law where the trust is sitused at the time the power is exercised. Therefore, if a trust is originally created outside of a state that has enacted decanting legislation, the trustee should be able to decant pursuant to the state's decanting statute once the trust is sitused in that particular state notwithstanding the fact that another jurisdiction's laws govern the validity, construction and the administration of the trust. Delaware codified this concept in its decanting statute which provides that Delaware's decanting statute is available to any trust that is administered in the State of Delaware, notwithstanding that another jurisdiction's laws may govern the trust. 12 Del. C. § 3528(f).

B. Implication of the *Peierls* decisions on Decanting.

The Delaware Supreme Court recently issued three separate related *en banc* opinions for the Peierls matters. In the Matter of the Peierls Family Inter Vivos Trusts, 2013 WL 5539329 (Del. Oct. 4, 2013); In the Matter of the Peierls Family Testamentary Trusts, 2013 WL 5526239 (Del. Oct. 4, 2013); and In the Matter of the Ethel F. Peierls Charitable Lead Unitrust, 2013 WL 5526243 (Del. Oct. 4, 2013). The opinions were authored by Chief Justice Steele, resulting from the appeal of three opinions of the Delaware Court of Chancery. The Delaware Supreme Court opinions in Peierls provide significant insight into various legal issues, including how to determine the administrative law, situs and jurisdiction of trusts.

The most critical holding in the Peierls opinions relates to the effect of changing the place of administration of the trust on the law that governs the administration of the trust. The Supreme Court concluded, contrary to the Chancery Court's analysis, that even if the trust contains a choice of law provision, and even if that choice of law provision references "administration", under the principles set forth in the Restatement (Second) of Conflicts of Laws the law governing the administration of the trust will change when the place of administration of the trust changes via a proper appointment of a successor trustee, unless the settlor has specifically stated his or her intent that a state's laws shall always govern the administration of the trust. This holding opens the door for the use of nonjudicial methods to modify trusts, such as decanting, when a trust is moved to a jurisdiction that permits the use of such a statute through the appointment of a successor trustee located in that jurisdiction.

C. Common Modifications Achieved by Decanting.

1. **Change in Governing Law.**

It is possible to utilize a state decanting statute to change the governing law for the original trust. For example, a trustee could utilize a decanting statute to distribute all of the assets of a trust governed in accordance with Delaware law into a new trust governed by Nevada law. As explained in more detail below, care must be taken to ensure that such a decanting does not have any negative implications on the generation-skipping transfer tax status of a GST exempt trust.

2. **Bifurcation of Trustee Responsibilities.**

Many states permit bifurcation of traditional trustee responsibilities through the appointment of trust advisers that have the ability to direct the trustee as to investment decisions, distribution decisions or other decisions typically held by the trustee. It is possible to utilize state decanting statutes to distribute all of the assets from a fully managed trust into a directed trust. The directed trust could create the position of investment adviser to direct the trustee with respect to investment decisions and distribution adviser to direct the trustee with respect to distribution decisions, while allowing the trustee to continue to be responsible for all administrative powers.

3. **Modification to Beneficial Terms.**

In certain situations it is desirable to utilize a state decanting statute to modify the beneficial provisions of a trust. As previously explained, many state decanting statutes permit a trustee to utilize the decanting power so as to reduce or eliminate certain rights and interests the beneficiaries have in the existing trust. For example, it may be possible to utilize a state decanting statute to eliminate a beneficiary's fixed income right or a beneficiary's right of withdrawal. As explained in more detail below, care must be taken in such a situation to ensure that no negative tax consequences result as a result of the reduction or elimination of the beneficiaries' rights or interests in the trust.

4. **Addition of Quiet Trust Language.**

Certain jurisdictions permit a trust instrument to eliminate a trustee's duty to inform beneficiaries of the existence of the trust for a period of time. For example, under the laws of certain jurisdictions a trust instrument could prohibit a trustee or other fiduciary from informing any beneficiary under the age of thirty-five (35) of the existence of the trust. This is often referred to as a "quiet trust."

It is possible to utilize certain state decanting statutes to convert a trust into a quiet trust. The new trust into which the assets of the existing trust are decanted would prohibit the trustees and other fiduciaries from disclosing the existence of the trust to the beneficiary for a period of time.

5. **Conversion of Trust for Income Tax Purposes.**

It may be possible to utilize a state decanting statute to convert a grantor trust into a non-grantor trust for income tax purposes or vice versa. This is often desirable for state income tax savings purposes. Certain jurisdictions do not tax income and capital gains accumulated in trust for ultimate distribution to beneficiaries that reside outside of such jurisdiction. By converting a grantor trust into a non-grantor trust it may be possible to reduce or eliminate any state income tax on the income and capital gain accumulated in trust for ultimate distribution to the beneficiaries.

6. **Division of Pot Trust into Separate Trusts.**

Often clients will create a single trust for the benefit of multiple beneficiaries (i.e. children) and grant the trustee discretion to distribute trust income and principal among such class of beneficiaries in the sole and absolute discretion of the trustee without equalizing distributions amongst the beneficiaries. Pot trusts can work well if the beneficiaries are in similar financial positions and have the same ideas regarding how and when distributions should be made from the trust. However, pot trusts can also cause a lot of resentment if a particular beneficiary is receiving larger discretionary distributions to the detriment of the other beneficiaries. State decanting statutes can be utilized to sever pot trusts into separate trusts for the benefit of individual beneficiaries so that the needs of one particular family line or beneficiary do not deplete the trust to the detriment of the other beneficiaries.

7. **Including Credit Shelter Trust in Beneficiary's Estate.**

Due to the increase in the federal estate tax exemption amount, it has become desirable in many situations to force the inclusion of a credit shelter trust in the surviving spouse's estate in order to provide for a step up in basis of the credit shelter trust's assets and therefore minimize income taxes upon the subsequent sale of those assets. For example, assume that husband died in 2001 leaving a credit shelter trust for the benefit of his surviving spouse which now has a value of approximately $2 million. Further assume, that the assets in the credit shelter trust have a very low basis compared to their fair market value and that the total combined value of the assets that wife has which would be includable in her gross estate for federal estate tax purposes is under $3 million meaning that wife's estate can absorb the $2 million credit shelter trust without the imposition of any federal estate tax which would allow the beneficiaries who receive the assets of the credit shelter trust upon wife's death to receive a step up in basis on such assets.

As previously mentioned, certain state decanting statutes permit the new trust to grant beneficiaries of the existing trust powers of appointment (including general powers of appointment) not otherwise set forth in the original trust. It could be possible for the trustee to exercise its authority under a state decanting statute to distribute all of the assets from the credit shelter trust into a new trust that is identical in all respects from a beneficial standpoint but which grants wife a testamentary general power of appointment over the trust assets. As a result of such general power of appointment, the trust assets will be includable in wife's estate for federal estate tax purposes and the assets will therefore receive a step up in basis upon wife's death.

D. Trustee Liability.

The decision to decant is typically in the sole and absolute discretion of the trustee. However, often it is the beneficiaries who have the desire to modify the terms of the governing instrument and who approach the trustee with a request to decant. This can put the trustee in a difficult position in that the trustee wants to accomplish the beneficiaries' goals but at the same time is concerned about the potential liability associated with the decanting.

For example, assume the beneficiaries approach the trustee with a request to decant all of the assets into a new trust which contains the same beneficial provisions but provides for an investment adviser to direct the trustee with respect to the investment of the trust assets. In the event the trust portfolio declines as a result of the investment performance by the investment adviser, the trustee could face a breach of fiduciary duty action from the beneficiaries as it was the trustee's sole discretion to decant the assets to a new trust which was no longer managed by the trustee.

Typically a trustee will require that all of the interested parties sign consent, release and indemnity agreements in connection with a decanting. However, there could be situations where it is not desirable from a tax standpoint to have a beneficiary consent to a particular decanting. The trustee must then decide whether it is willing to decant the assets as requested by the beneficiary in light of the potential liability.

E. IRS Action.

The Internal Revenue Service has recognized that decanting is an emerging issue with tax consequences that are not entirely clear under current law. In 2011 decantings were added to the "no ruling list" pursuant to Rev. Proc. 2011-3.

The Internal Revenue Service recently issued a notice (IRS Notice 2011-101) requesting comments on the tax implications of trust decantings that result in a change in the beneficial interests in the trust. For purposes of the notice, a change in beneficial interests occurs when the

interests of one or more beneficiaries of the first trust are changed or terminated under the second trust and/or when the second trust adds a beneficiary who did not have any interest under the first trust.

Several organizations, including the Delaware Bar Association, through the Estates & Trusts Section, and the Delaware Bankers Association, have filed responses to IRS Notice 2011-101. Provided below is a list of the tax issues the IRS is requesting comment on:

1. **Income Tax Issues:**

   i. Whether the existence of a decanting power causes the trust to be treated as a grantor trust under Internal Revenue Code ("IRC" or "Code") § 671.

   ii. Whether the distribution of property from one trust to another trust through a decanting should be treated as a distribution requiring the calculation of distributable net income ("DNI").

   iii. Whether the distribution from one trust to another will cause the trust to recognize gain under IRC § 1001, if the trust holds appreciated assets.

   iv. Whether the distribution from one trust to another will cause any beneficiary of the distributing trust to recognize gain under IRC § 1001.

   v. Whether a trust that receives all of the assets of the decanted trust receives the tax attributes of the first trust.

2. **The Gift and Estate Tax Issues:**

   i. Whether a beneficiary whose interests are diminished as a result of the decanting has made a taxable gift.

   ii. Whether a beneficiary whose interests are diminished as a result of the decanting has made a transfer for purposes of IRC § 2036 or § 2038.

   iii. Whether the existence of a decanting power in a trust that otherwise qualifies for an estate or gift tax marital deduction under IRC § 2056(b)(7) will cause the trust to fail to qualify for the marital deduction.