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Decanting Pre-ATRA Trusts

An Interview with Meryl G. Finkelstein, Esq.

By Robert L. Moshman, Esq.

Decanting a fine wine can enhance its flavor when done properly. Awaken the grapes and celebrate life! However, a wine decanting miscue can leave you with woe and sorrow, not to mention a sour taste, an expensive bottle that no one wants, the scorn of afficiandos and a decanter that needs to be washed out and put away.



Decanting assets from a trust can be equally tempting and rewarding, especially in the wake of the American Taxpayer Relief Act of 2012 (ATRA). However, there are many more considerations and variables than one might think. States have different statutory and common law parameters and the IRS may also have something to say about decanting from a trust.

Presented With Our Compliments

Decanting Wine Looks Simple

Bonjour! Today we shall see that transferring funds from an existing trust to a new trust is as simple as decanting wine from a bottle to a decanter. Here's how it works with wine.

Step #1: Open zee wine.

Step #2: Pour zee wine into zee decanter. Voilà!

No, no, no! Sacré bleu! Arrêtez s'il vous plaît! Wine connoisseurs are cringing at the previous instructions (and not merely at the faux français).

Decanting wine is both an art and a science. One doesn't just oxygenate a Beaujolais the same way as a Lafite Bordeaux! Older wines are more fragile. There are crucial adjustments for age and origin. Every vintage is different.

And what of the sediment, Monsieur? There are surgeries less complex than the detailed procedures for positioning the bottle, removing the cork, and pouring wine into a decanter. Temperature and timing are also critical. The stakes could not be higher—channel one's inner grape or you'll end up drinking vinegar.

Decanting Trust Assets

The analogy of decanting wine is suitable to trust assets in that the process looks easy, but there are many details to consider.

A trustee with the power to invade the principal of a trust should, in theory, be able as an extension of that power to have the authority to decant assets from one trust and re-establish them in another trust. In this way, a trustee could overcome a variety of problems and make improvements.

But let's get right to the bottom line: Whose ox would be gored by a given decanting? If the decanting has a negative impact on a beneficiary's interests, will there be a lawsuit?

Bear in mind that the flashpoint for a grievance may not be as obvious as an existing beneficiary being excluded when decanted assets are transferred into a new trust. A shift in assets or investment philosophy may represent a shift in favor of equity growth instead of income and may enhance the interests of remaindermen at the expense of income beneficiaries—or may be perceived that way.

Will aggrieved beneficiaries bring a legal action that is viable enough to survive dispositive motions? Could the action even prevail? And, if so, would there be liability for the fiduciaries and malpractice claims against their professional advisers?

“The use of decanting is definitely not an academic issue . . . Given the right trust and the right set of facts and circumstances, decanting can be a powerful and often economical tool for modifying an irrevocable trust.”

—Meryl G. Finkelstein, Esq.

The starting point for answers will be the terms of the trust itself. If the trustee already has broad authority over trust investments and distributions, and if the beneficiaries are not altered, then decanting may not be changing the respective interests of any trust beneficiaries.

Shall We Decant?

Haven't trust draftsmen incorporated trust flexibility and trust protectors into standard trusts? Aren't modern trustees routinely granted authority to depart from the prudent man limitations on investing that tied down fiduciaries of the past?

Aren't trustees frequently permitted to invest in family businesses, accumulate trust income, invade trust principal, and distribute unequal amounts to trust beneficiaries?

All the previous statements are true and then some. Yet the most flexible of trusts gets trampled under changing variables. Life happens. Even when an elegantly designed trust anticipates all the vicissitudes, it is human nature to prefer a clean start. It may also be faster and more economical to decant using trust and statutory authority rather than some of the alternatives.

A trust may also face an untenable situation with limited alternatives. It may be disadvantaged simply by operating in a particular jurisdiction, or it may have the wrong assets that are generating too much taxable income. There may be a particular term that needs to be modified or a term that is missing. While a court proceeding might take a lot of time and money with no certain outcome, decanting may offer a swift and sensible solution.

ATRA Gotcha

One of the most untenable and unreasonable sequences of events ever to play out in the history of transfer tax legislation was tied to the year-end fiscal cliff drama.

There was a deadline-inspired wave of gifts in trust at the conclusion of 2012 and the subsequent imposition of significantly higher taxes on many of those trusts as a result of the American Taxpayer Relief Act of 2012 (ATRA) that was enacted at the start of 2013.

Taxpayers and estate planners were forced to plan for a potentially irrational Congress allowing the fiscal cliff scenario to play out. So assets were loaded hastily into trusts in the waning days of 2012 like lucky passengers getting the last spots on Noah's Ark after it had started raining.

But, lo! Congress did not have us revert to a \$1 million transfer tax exemption or compromise with a \$3.5 million non-portable exemption. Congress



maxed out on the estate tax exemption with \$5,250,000 exemptions per person for 2013, with indexing for inflation and portability of unused exemptions for spouses.

So many of the income-producing or appreciation assets that were loaded into trust “arks” ended up being subject to higher income tax rates as a result of ATRA when they would have been better off remaining in the grantor’s estates, also as a result of ATRA.

A number of the hastily drafted trusts may have had other undesirable attributes resulting from the haste and volume of activity from that unfortunate sequence. In the aftermath of these ATRA-related trust afflictions, the decanting option has been mentioned often.

A Multiplicity of Decantation

Decanting trust assets is not a brand-new technique. The common law supports the decanting of trust assets to some extent, and the technique has been used for many years. A trustee with authority to invade principal should be able to do so and transfer the proceeds to another trust that continues to provide for the same beneficiaries.

The use of decanting has been expanding in recent years as statutory guidance has been provided in a growing number of states. In 1992, New York adopted a decanting statute, and several states began following suit. Ten years later, there were still less than ten states with statutes on point. Yet a progression of additional states has continued to look into the decanting approach; in 2011, New York circled back to modernize and expand upon its decanting approach.

How will a particular decanting effort turn out? The answer is literally all over the map. There are now 18 different state statutes that impose different rules. There are other case law precedents controlling in other jurisdictions. Trusts themselves may have terms controlling the extent of decanting.

**“God made Man,
Frail as a Bubble;
God made Love,
Love made Trouble;
God made the Vine;
Was it a Sin
That Man made Wine
To drown Trouble in?”
— Oliver Herford**

Many jurisdictions agree on certain decanting rules. Thus, no state decanting statute directly permits the addition of beneficiaries. However, some statutes, such as Alaska’s, allow for the acceleration of remainder interests to present interests under the second trust, and some statutes permit a beneficiary of the first trust to be granted a power of appointment under the second trust that is exercisable in favor of persons who were not beneficiaries of the first trust.

Decanting statutes have been enacted in the following states:

Alaska	Arizona
Delaware	Florida
Indiana	Kentucky
Illinois	Missouri
Nevada	New Hampshire
New York	North Carolina
Michigan	Ohio
Rhode Island	South Dakota
Tennessee	Virginia

Decanting legislation is currently pending in South Carolina. Decanting legislation has also been proposed by the Trust and Estates Section of the Colorado Bar Association. A drafting committee of the Uniform Law Commission has started work on a Uniform Statute that may be added to the Uniform Trust Code or become a freestanding Act.

Decanting is becoming widespread, but can it be used as an all-purpose do-over for trusts? That thinking invites bad planning. Good practice means planning trusts that are adaptable and lasting. Nevertheless, we have entered the age of decanting options, and the modern trust should incorporate provisions that empower trustees to use this powerful tool to effectuate the purposes of the trust as originally designed on behalf of the grantor.

Decanting Trust Strategies

An Interview with Merly G. Finkelstein, Esq.

Assisting us with great insight into the emergent area of decanting trusts is one of the nation’s foremost authorities, attorney Meryl G. Finkelstein.

Q: There has been a growing number of jurisdictions with decanting statutes in recent years. Do you anticipate the trend increasing?

A: There are currently 18 states with decanting statutes. Six of those statutes were enacted in 2012. I would expect the trend to continue as more state legislatures recognize the importance of enacting decanting statutes as a way of modifying otherwise irrevocable trusts. In 2011, the IRS recognized the increasingly widespread use of decanting when it issued *Notice 2011-101*, which sought guidance from practitioners

regarding the tax consequences of a trust decanting that changes beneficial interests.

Q: Have you encountered much use of decanting among your clients, or is this mainly an academic issue?

A: The use of decanting is definitely not an academic issue. We frequently decant trusts, and we do so for a variety of reasons. These can include modernizing or updating outdated trust provisions, addressing changes in beneficiary circumstances, changing a trust's governing law and situs, or changing the income tax status of a trust. We have also used decanting as a way of segregating assets in order to avoid adverse income tax consequences at the state tax level. Given the right trust and the right set of facts and circumstances, decanting can be a powerful and often economical tool for modifying an irrevocable trust.



beneficiary-trustee can act in order to avoid possible adverse gift and estate tax consequences.

Q: Some trusts anticipate the use of decanting, but could other trust terms interfere with decanting techniques?

A: Planners need to consider whether the dispositive provisions of the trust they are drafting might prevent use of the state's decanting statute, such as a trust that will be governed by Florida law where distributions are subject to a standard. In that case, the Florida decanting statute won't be available. Other statutes permit the decanting of trusts with distribution standards, but don't allow those standards to be altered under the second trust.

The more inflexible the manner in which a trust is drafted, the less likely it is that future changes will be able to be made through a decanting.

Q: Is there a tax context for decanting?

A: Planners must be aware of the potential tax consequences of a trust decanting, particularly if the trust is either grandfathered from the GST tax or has had GST exemption allocated to it. Planners must also consider whether a proposed decanting has any potential income, estate or gift tax consequences. If the decanting is being implemented in order to change a trust's administrative provisions, then it is less likely that the decanting will have adverse tax consequences. But particularly where beneficial interests are being altered, unintended tax consequences, including a loss of grandfathered or exempt status, may result.

Q: Where might decanting downsides be encountered?

A: From an income tax perspective, the nature of the assets that are held by the first trust should also be considered, particularly where the trust holds property with debt in excess of basis or partnership interests with negative capital accounts. Planners also need to make sure that any changes in beneficial interests from the first trust to the second trust are authorized by the applicable state's decanting statute and consider how trust beneficiaries will react to such changes.

Q: Can a beneficiary who is also a trustee utilize decanting?

A: Where the trustee is an actual or potential beneficiary of the first trust, the use of decanting may be affected. Some decanting statutes prohibit a beneficiary-trustee from acting altogether, while others limit the circumstances under which a

Q: Would you recommend decanting as a strategy going forward, or are there alternatives you find more useful?

A: Decanting is an extremely useful strategy, and planners should consider including a specific decanting provision in their trust agreements and wills, particularly if they practice in a state that does not have a decanting statute. Even if their state does have a decanting statute, especially one that is restrictive, including a decanting provision in the trust instrument can provide enhanced flexibility. There are situations, however, where decanting won't be available, such as a trust that does not permit current distributions of principal. In addition, none of the decanting statutes permits the addition of beneficiaries (except under some statutes through the granting of a power of appointment in the second trust). In those situations, the use of other alternatives, such as judicial modification, may be necessary.

Meryl G. Finkelstein, Esq., a Senior Counsel at Fulbright & Jaworski L.L.P., 666 Fifth Avenue, New York, NY 10103, has extensive experience in the development and implementation of sophisticated estate and wealth transfer plans. She is a frequent lecturer on the topic of trust decanting and was a member of the joint subcommittee of the New York City Bar Association that proposed the changes to the New York decanting statute that became effective in August 2011. Ms. Finkelstein was also a member of the subcommittees that prepared comments to IRS Notice 2011-101 on behalf of the New York City Bar Association and the Real Property, Probate & Trust Law Section of the American Bar Association.

