

Decanting and the Generation-Skipping Transfer Tax: Pitfalls and Possibilities

Amy Erenrich Heller¹
Weil, Gotshal & Manges LLP
New York, New York
Amy.Heller@weil.com

Introduction

Decanting has become an increasingly popular tool to modify irrevocable trusts. Decanting refers to a trustee's appointment of trust property to another trust. Decanting may be desirable for many reasons, including extending the term of a trust, adding a spendthrift provision, altering trustee provisions, changing governing law, converting a grantor trust to a nongrantor trust or the reverse, and correcting drafting errors. Decanting has become more prevalent as a growing number of states have adopted statutes allowing trustees to distribute trust property to other trusts, and as practitioners have begun to include provisions that mimic state decanting statutes in their trust agreements.²

Part I of this outline examines the requirements of the New York decanting statute and provides a sample decanting provision modeled on the New York statute that can be incorporated into a trust agreement. Part II of the outline considers the special care that must be taken in decanting a trust that is exempt from the generation-skipping transfer ("GST") tax in order to avoid jeopardizing the trust's GST exempt status. Part III describes a technique that uses decanting to defer the imposition of a GST tax upon a taxable termination of a trust that is not exempt from the GST tax.³

¹ I am grateful to Carlyn S. McCaffrey for suggesting and discussing several points in this outline and to Alex Raskolnikov for helpful comments.

² At least seven states have enacted decanting statutes. *See* Alaska Stat. § 13.36.157 (Alaska), Del. Code Ann. tit. 12 § 3528 (Delaware), Fla. Stat. Ann. § 736.04117 (Florida), RSA 564-B:4-418 (New Hampshire), New York Estates, Powers and Trusts Law § 10-6(b) (New York), S.D. Codified Laws § 55-2-15 (South Dakota) and Tenn. Code Ann. § 35-15-816(b)(27) (Tennessee). Several other states are considering similar legislation.

³ For excellent, more comprehensive discussions of the tax and state law issues implicated by decanting, see Alan S. Halperin and Lindsay N. O'Donnell, "Modifying Irrevocable Trusts: State Law and Tax Considerations in Trust Decanting," 42 Ann. Heckerling Inst. on Est. Plan. (2008); Jonathan G. Blattmachr and Diana S.C. Zeydel, "An Update on Decanting Statutes," Materials Submitted in Connection With Fall 2008 RPTE Meeting; Alan Halperin and Michelle Wandler Albrecht, "Decanting Discretionary Trusts: State Law and Tax Considerations," 29 Tax Management Estates, Gifts & Trusts Journal (September 9, 2004).

I. New York Decanting Statute and Sample Trust Language

A. NY EPTL § 10-6.6(b). New York was the first state to adopt a decanting statute when § 10-6.6(b) of the New York Estates, Powers & Trusts Law (the “NY EPTL”) was enacted in 1992.

1. Substantive requirements of NY EPTL § 10-6.6(b). Section 10-6.6(b) of the NY EPTL authorizes the trustees of a trust (the “original trust”) to distribute property to another trust (the “receptacle trust”) if the following requirements are satisfied:

a. Discretion to invade principal. The trustees of the original trust must have unfettered discretion to invade the principal of the original trust.

i. This requirement will not be satisfied if the trustees’ ability to invade principal is limited by an ascertainable standard, such as health, education, support and maintenance).⁴

b. No reduction of fixed income right. The distribution of property from the original trust to the receptacle trust cannot reduce the fixed income right of any beneficiary of the original trust.

i. This requirement may limit the ability of trustees to decant marital deduction or other trusts with mandatory income interests. However, it poses no constraint on the decanting of a discretionary trust.

c. In favor of proper objects. The exercise of the trustees’ power to distribute property of the original trust must be in favor of one or more of the “proper objects of the exercise of the power.”

i. The term “proper objects of the exercise of the power” is not defined in the NY EPTL. However, it generally is understood to mean persons to whom distributions could be made from the original trust.

d. Cannot violate public policy. The receptacle trust cannot contain provisions that violate public policy.

e. Cannot violate perpetuities period measured by original trust. The exercise of the trustees’ power to distribute property of the original trust cannot extend the perpetuities date as measured by reference to the original trust. *See* § 10-6.6(f) of the NY EPTL, which

⁴ *See Estate of Mayer*, 672 N.Y.S.2d 998 (Surr. Ct. N.Y. Cty. 1998).

provides that the exercise of the trustees' power is treated for perpetuities purposes as the exercise of a power of appointment.

2. Procedural requirements of NY EPTL § 10-6.6(b). If the substantive requirements described above are satisfied, the trustees of the original trust must follow the procedures identified in NY EPTL § 10-6.6(d) in order to effectuate the distribution of property to the receptacle trust. These procedures include the filing of an instrument with the court having jurisdiction over the trust and the service of copies of this instrument on "all persons interested in the trust."⁵

- B. Decanting pursuant to a provision of a trust agreement. In order to avoid a court filing and service upon persons interested in the trust, some New York practitioners have begun including decanting provisions in their trust agreements by incorporating the substantive requirements of NY EPTL § 10-6.6(b) while omitting the procedural requirements of the statute. For example:

"Distributions to Trusts. If the Independent Trustees of a Trust (the "original Trust") have the discretion to pay a portion (or all) of the Trust Fund of the original Trust (the "permitted portion") to or for the benefit of any one or more beneficiaries of such Trust (the "original discretionary beneficiaries"), such Independent Trustees may exercise such discretion by directing the payment of any part or all of the permitted portion to the trustee or trustees of another trust for the benefit of one or more of the original discretionary beneficiaries (the "recipient trust"), provided, however, that (i) the recipient trust does not direct or permit payments to or applications by the trustees for the benefit of any person other than one or more of the beneficiaries of the original Trust, (ii) the recipient trust does not reduce any fixed income interest of any income beneficiary of the original Trust, (iii) the recipient trust ends no later than the perpetuities date of the original Trust, and (iv) the Independent Trustees give each beneficiary of the original Trust written notice of his, her or its intention to make such direction at least thirty (30) days before making the direction. For purposes of clause (i) of the preceding sentence, the beneficiaries of the original Trust shall include all beneficiaries of such Trust, whether original discretionary beneficiaries, income-only beneficiaries or remaindermen, and for purposes of clause (iv) of the preceding sentence, the beneficiaries of the original Trust shall include only those persons who are competent and to whom current distributions from such

⁵ Persons interested in the trust include persons who would need to be served in a judicial accounting proceeding.

Trust may be made. Notwithstanding the first sentence of this section, the terms of the recipient trust may provide any one or more of the original discretionary beneficiaries with a power of appointment exercisable in favor of one or more individuals, regardless of whether any such individual is a beneficiary of the original Trust.”

Practitioners in states that do not yet have decanting statutes may also wish to include a similar provision (or a provision that more closely tracks the decanting statute of a state other than New York) in their trust agreements in order to give trustees the flexibility to distribute property to other trusts pursuant to the terms of the trust agreement.

II. Decanting an Exempt Trust Without Jeopardizing GST Exempt Status

- A. The concern. If a trust is exempt from the GST tax, special care must be taken in decanting the trust pursuant to a state statute or a provision of the trust agreement. This is because a distribution of property from a trust that is exempt from the GST tax to another trust risks jeopardizing the GST exempt status of the original trust.
- B. Modifications of grandfathered trusts under the “effective date” regulations. Treas. Reg. § 26.2601-1(b)(4) provides rules for determining whether a “grandfathered trust” (*i.e.*, a trust that is exempt from the GST tax because it was irrevocable on September 25, 1985 and because no subsequent additions to the trust have been made) will retain its GST exempt status following a modification or other action by a trustee, including the exercise of a trustee power to appoint trust property to a new trust.⁶
 1. Special rule for decanting a grandfathered trust. Treas. Reg. § 26.2601-1(b)(4)(i)(A) provides that a distribution of trust principal from a grandfathered trust to a new trust will not cause a loss of GST exempt status if the following two requirements are satisfied:
 - a. Distribution pursuant to trust agreement or pre-effective date state law. Either (i) the terms of the governing instrument of the grandfathered trust authorize distributions to other trusts, without the consent or approval of any beneficiary or court or (ii) at the time the grandfathered trust became irrevocable, state law authorized distributions to other trusts, without the consent or approval of any beneficiary or court.⁷

⁶ Treas. Reg. § 26.2601-1(b)(4) also applies to Wills or revocable trusts executed before October 22, 1986, if the decedent died before January 1, 1987, and if no additions were made on or after October 21, 1986. *See* Treas. Reg. § 26.2601-1(b)(2).

⁷ Treas. Reg. § 26.2601-1(b)(4)(i)(A)(1).

- i. As stated above, New York was the first state to enact a decanting statute in 1992, seven years after the GST tax was enacted. Accordingly, the prong of Treas. Reg. § 26.2601-1(b)(4)(i)(A) that requires decanting to have been permissible under state law in effect at the time the grandfathered trust became irrevocable cannot be satisfied on the basis of the decanting statute of New York or any other state.⁸
- b. Cannot violate perpetuities period measured by original trust. The terms of the governing instrument of the receptacle trust cannot extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond a period measured by 21 years after the death of any life in being at the time the original trust became irrevocable.⁹
 - a. In a state that has a traditional rule against perpetuities (e.g., New York), this requirement will ordinarily need to be satisfied in order for a decanting to be valid under state law. See e.g., NY EPTL § 10-6.6(f), described at I.A.1.e, above.
 - b. In a state that has abolished the rule against perpetuities (e.g., Delaware), decanting a perpetual trust into another trust that is also perpetual would appear to violate this requirement. However, because such a decanting will not extend the time for vesting of any beneficial interest in the original trust beyond a period that was permissible based on the original trust, it seems that the requirement should in fact be satisfied. The same logic should apply in the case of a state that has adopted an elongated perpetuities period (e.g., Florida).

⁸ There is an argument that this requirement can be satisfied based on common law as it existed in certain states at the time the GST tax was enacted. In the case of New York law, see Memorandum in Support of Legislation, Governor's Bill Jacket, 1992 chapter 591, at 4, suggesting that NY EPTL § 10-6.6(b) clarified existing law. In the case of Florida law, see *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940).

⁹ Treas. Reg. § 26.2601-1(b)(4)(i)(A)(2). For this purpose, the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that does exceed ninety years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. *Id.*

2. Other modifications of grandfathered trusts. If the special effective date rule for grandfathered trusts that are decanted (described at 1, above) cannot be satisfied because (i) the terms of the governing instrument of the grandfathered trust do not authorize distributions to a further trust without the consent or approval of any beneficiary or court and (ii) applicable state law in effect at the time the grandfathered trust became irrevocable did not permit the trustees to appoint property to a further trust, but applicable state law now permits the trustee to appoint property to a further trust, there is an alternative safe harbor that may allow the trust to be decanted without disruption of its GST exempt status. Specifically, Treas. Reg. § 26.2601-1(b)(4)(i)(D) provides that distribution of property of a grandfathered trust to a new trust will not cause GST grandfather protection to be lost if the following two requirements are satisfied:
 - a. No shift in beneficial interest to a lower generation. The distribution does not cause a beneficial interest to be shifted to a beneficiary in a lower generation for purposes of the GST tax.¹⁰
 - b. No extension of time for vesting. The modification does not extend the time for vesting of any beneficial interest in the original trust beyond the period provided for in the original trust.

- C. Modifications of trusts exempt from GST tax due to allocation of GST exemption. If a trust is exempt from the GST tax as a result of the allocation of GST exemption (rather than because of the trust's grandfather status), there is no Treasury Regulation that addresses whether a modification to the trust or other action by the trustees, including the exercise of a trustee power to appoint the trust fund to a new trust, will cause the trust to lose its GST exempt status. Private letter rulings have extended the "effective date" regulations described above at B to trusts that are exempt from the GST tax as a result of an allocation of GST exemption.¹¹

¹⁰ A beneficiary's generation assignment is determined pursuant to the rules of Code § 2651.

¹¹ See Priv. Ltr. Rul. 200822008 (May 30, 2008) ("No guidance has been issued concerning the GST tax consequences of the modification of a trust created after September 25, 1985. At a minimum, a modification that does not affect the exempt status of a trust that is not subject to the GST tax because it was irrevocable on to September 25, 1985 should similarly not affect the inclusion ratio of a trust created after September 25, 1985."). See also Priv. Ltr. Rul. 200743028 (May 29, 2007); Priv. Ltr. Rul. 200714016 (April 6, 2007).

III. Using Decanting to Defer the Imposition of a GST Tax

While decanting a trust that is exempt from the GST can jeopardize GST protected status, decanting a trust that does not benefit from GST tax protection can be used as a tool to defer the imposition of an impending GST tax.

If a taxable termination will occur with respect to a trust that is not exempt from the GST tax upon the death of a non-skip person beneficiary, it may be possible to defer the imposition of the GST tax if, before the occurrence of the taxable termination, property is distributed from that trust to a receptacle trust that is not a skip person.¹²

If the receptacle trust were a skip person, the appointment of the original trust's property by its trustee to a receptacle trust itself would be treated as a taxable distribution.¹³ A trust is not a skip person if there is no person with an interest in the trust for GST tax purposes,¹⁴ and distributions may be made to a non-skip person after the transfer.¹⁵ To meet these requirements, the receptacle trust could provide, for example, that no distributions can be made from the trust to any person for a period of three years after the property is received from the original trust. It could then provide for distributions to be made in the discretion of the trustees to individuals who are skip persons and to charities. Because charities are non-skip persons, the receptacle trust would be a non-skip person. Any property distributed from the original unprotected trust to the receptacle trust in this case would avoid the GST tax until a distribution is made to a skip person or until death of one of the skip persons.

¹² A taxable termination is the termination of an individual's interest in a trust if no person other than skip persons have present interests in the trust immediately after such termination unless a transfer subject to federal estate or gift tax occurs with respect to the trust property at the time of the termination and provides a new transferor for the property. Code § 2612(a); Treas. Reg. § 26.2612-1(b).

¹³ A taxable distribution is a distribution from a trust to a skip person unless the distribution is a taxable termination or a direct skip. Code § 2612(b); Treas. Reg. § 26.2612-1(c).

¹⁴ An individual is considered to have an interest in a trust for GST tax purposes if he has a present right to receive income or principal distributions from the trust or is a person to whom current distributions of income or principal may be made. A charity is deemed to have an interest in a trust for GST tax purposes only if it has a present right to receive income or principal distributions from the trust, unless the trust is a charitable remainder trust or a pooled income fund. Code § 2652(c); Treas. Reg. § 26.2612-1(e).

¹⁵ Code § 2613(a)(2)(B).