BUT I THOUGHT IT WAS IRREVOCABLE?: HOW TO USE TRUST MODIFICATION TECHNIQUES TO MODERNIZE TRUSTS

Michael M. Gordon
Michaelle D. Rafferty

Michael M. Gordon
Gordon, Fournaris & Mammarella, P.A.

MICHAEL M. GORDON is a Director at the Wilmington law firm of Gordon, Fournaris & Mammarella, P.A. He is a graduate of Fairfield University and the Catholic University of America, Columbus School of Law. He received his Masters of Law in Taxation from Villanova University School of Law in 2008 and is a member of the Delaware and Maryland Bar Associations.

Michael is the former Chair of the Estates and Trusts Section of the Delaware Bar Association. He is a Fellow of the American College of Trust and Estate Counsel. Michael frequently lectures throughout the country on various estate planning topics.

Michael's practice focuses on the unique aspects of Delaware trust law, including directed trusts, dynasty trusts, asset protection trusts and all aspects of the validity, construction and administration of Delaware trusts. Michael routinely works with clients across the country to create Delaware trusts and to move existing trusts to Delaware to take advantage of Delaware's favorable trust law. Michael drafts, reviews and comments on Delaware trust agreements for local and out of state clients and provides legal opinions on the validity of trusts under Delaware law.

Michaelle D. Rafferty
Maupin, Cox & LeGoy

Michaelle DiGrazia Rafferty ("Michaelle") is a shareholder attorney in the law firm of Maupin, Cox & LeGoy, exclusively practicing in the areas of high net worth estate planning, taxation, administration of trusts and estates, and family trust company planning and operations. Michaelle also practices in fiduciary related litigation, audit related matters, and provides expert witness services. Michaelle has been admitted as a Fellow of the American College of Trust & Estate Counsel (ACTEC) where she serves as a Regent and the Nevada State Chair. Michaelle is a past Chair of the Nevada State Bar - Probate & Trust Section where she served as an executive officer for the previous 8 years. She is a current Co-Chair of the Section's Legislative Committee for Nevada, including drafting and testifying on pending legislation before the Nevada legislature, and appearing before the Nevada Supreme Court on matters of trust and estate litigation. She serves as the Court-appointed member of the Nevada Supreme Court's Bench-Bar Committee representing interests of trust and estate counsel. Michaelle is a founding and current Executive Officer for the Probate Bar Association of Washoe County, and has previously served as Executive Officer of the Washoe County Bar Association. She is also a long-standing member of the Northern Nevada Estate Planning Council, and is a frequent speaker and presenter for both national and state continuing education courses related to her areas of practice. Michaelle holds seven "Lawyer of the Year" designations from Best Lawyers, including for 2025 in planning and litigation. She is a Chambers Tier 1 designee for high net worth planning, the past Chair of Cambridge Forum's Fiduciary Litigation Forum and a planning committee member for Cambridge Forum's Private Wealth Forum. Michaelle represents diverse clientele including individuals, families, entities, private and commercial trust companies, university foundations, financial institutions, private and public foundations, family offices and private family trust companies. In her free time, Michaelle can be found skiing, hiking, running, biking, or kayaking in the Sierra Nevada mountains and lakes.

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I. Why Do Clients Want to Modernize Trusts and Typical Changes Made to Trusts.

A. Beneficial Provisions no Longer Work

1. Family Changes

a. Marriage

The terms of an existing trust instrument may provide that all of the trust income is to be distributed to the grantor's children. The income the beneficiaries receive from the trust may be a source of support that is used to sustain the lifestyle of the beneficiary and the beneficiary's spouse.

A beneficiary may have a concern that if the beneficiary were to predecease the beneficiary's spouse the spouse would not be able to continue the lifestyle they enjoyed while the beneficiary was living. It could be possible to update the provisions of the existing trust pursuant to a NJSA or decanting so as to grant a beneficiary a limited power of appointment he or she could exercise to appoint an income stream from the trust to a spouse so that the spouse could continue to live the same lifestyle.

b. Divorce

As a result of a change in marital status the terms of an existing trust may no longer accomplish the desired goal of the grantor in creating the trust or be advantageous to the trust beneficiaries. A trust beneficiary may be going through a divorce and the terms of the existing trust instrument may provide that all of the income is to be distributed to the trust beneficiary and/or that the trust assets are to be distributed outright to the beneficiary upon attaining certain ages. The provisions contained in the existing trust could result in a portion or all of the trust assets being includable in the marital estate for purposes of equitable division of marital assets, which would be inconsistent with the grantor's intent in establishing the trust.

c. Birth or Adoption

The terms of the existing trust instrument may define the term children or issue in a way that was not intended by the grantor. The trust instrument could provide that adopted children are not to be considered beneficiaries of the trust or alternatively that a child adopted at any age may be considered a beneficiary of a trust, which would allow for adult adoptions. The terms of the trust instrument may also exclude children born out of wedlock or fail to account for children born after the execution of the trust.

2. Changes in Beneficiary's Life

a. Spendthrift and Substance Abuse

The terms of the existing trust may grant a trust beneficiary certain powers or rights over the trust which are no longer desirable. For example, the terms of the existing trust instrument may provide that the beneficiary is to receive all of the income from the trust, grant the beneficiary principal withdrawal rights upon attaining certain ages or otherwise allow the beneficiary to participate in distribution decisions by serving as a trustee or co-trustee. While those provisions may have been consistent with the grantor's intent in creating the trust, it is possible that as a result of the beneficiary's substance abuse problems or spendthrift issues it is no longer desirable for the beneficiary to have such rights and powers over the trust as doing so could be detrimental to the beneficiary.

b. Restrictive Provisions

Oftentimes a grantor will establish a trust for the benefit of the grantor's descendants for very specific purposes such as payment of a beneficiary's post high school education or health care needs. Due to a change in circumstances the restrictive beneficial provisions may no longer be practical.

The trust may have grown to such a size with where it is desirable to make distributions for other purposes so as to spend down the trust. In addition, the educational and health care needs of the beneficiaries may be covered by other resources.

A grantor may have also established a trust for a very narrow purpose under the mistaken belief that the beneficiaries would have ample resources available to them for other purposes and it would be unlikely that the trust assets would ever be needed for the beneficiary's support. Due to a financial change in circumstances of a beneficiary it may be desirable to invade the corpus of the trust for a broader purpose which would have been consistent with the grantor's intent if he or she would have known the beneficiaries' financial position in the future.

c. Division of Pot Trust into Separate Trusts

A grantor may have established a pot trust for the collective benefit of the grantor's five children and their descendants. Based on a change in financial situation of one of the children, such child may become reliant upon distributions from the trust to support the child and the child's descendants. This may cause discord among the remaining siblings as distributions made to the child would deplete the trust to the detriment of the other children and their descendants.

In this situation it could be desirable to engage in a trust to trust transfer to sever the pot trust into five separate trusts, one for the benefit of each child and such child's descendants. This would prevent disproportionate distributions to the children from causing problems among the children.

B. Outdated Administrative Provisions

1. Fiduciaries

a. Trustee Requirements

The existing trust may contain certain requirements for the appointment of trustees which are no longer desirable due to a change in circumstances, such as a diminishment in value of the trust or the nature of the assets currently owned by the trust. The trust may require that at all times a corporate trustee serve but due to the relatively low value of the trust this provision is no longer desirable as it is not economical to administer the trust with a corporate trustee.

The trust may also own certain assets that a corporate trustee would be uncomfortable administering. For example, the trust may have a concentrated position in a particular stock or an ownership interest in the family business.

The beneficiaries and grantor may want to update these provisions to change the requirements regarding the appointment of trustees.

b. Bifurcation of Trustee Responsibilities

In a traditional trust the trustee is responsible for all facets of the trust administration (i.e., investment decisions, distribution decisions and administrative decisions). For a variety of reasons it may be desirable to separate these responsibilities among different fiduciaries. It could be possible through an NJSA or other modification technique to bifurcate or trifurcate traditional trustee responsibilities so that one fiduciary is responsible for the

investment of the trust assets, another fiduciary is responsible for the distribution of the trust assets and a third fiduciary is responsible for the administration of the trust.

c. Succession of Trustees

The existing trust may not be entirely clear on the mechanism for the succession of trustees. In fact, the existing trust may not even contain a mechanism permitting the resignation or removal of a trustee and the appointment of a successor trustee.

It may be desirable to have the parties enter into a NJSA to clarify the provisions regarding the succession of trustees or otherwise add provisions relating to the succession of trustees.

2. Other Administrative Updates

a. Notification Requirements

Most jurisdictions require trustees to keep beneficiaries reasonably apprised of their beneficial interest in a trust. For example, the Uniform Trust Code requires that qualified beneficiaries be informed of the existence of the trust and their beneficial interest in the trust.

Due to a change in circumstances it may not be in the best interest of the beneficiaries for them to become aware of the existence of the trust as it could be a disincentive for them to achieve their own success or cause other issues in their lives. This is particularly true with younger beneficiaries or beneficiaries that have substance abuse or spendthrift problems.

Certain jurisdictions permit the use of silent trusts where a trust instrument may eliminate the trustee's duty to inform beneficiaries of the existence of a trust for a period of time. It may be desirable to engage in a trust to trust transfer so as to change the notification requirements to protect the beneficiaries.

b. Lack of Investment Flexibility

The terms of the existing trust may contain provisions mandating that the trust assets only be invested in certain types of investments. Due to a change in the financial markets these limitations may stifle the growth of the trust and no longer be desirable.

The existing trust may also contain provisions which do not necessarily restrict how the trust assets may be invested but require the trustee to abide by the prudent person rule. The trust may be funded with a concentrated position or an ownership interest in the family business and the beneficiaries may not want to diversify such position.

c. Allocation of Income and Principal

The existing trust may have outdated provisions relating to the allocation of income or principal. The existing trust may also prohibit the trustees from converting an income only trust to a unitrust in situations where it will be desirable to do so.

C. Outdated Tax Planning.

1. Income Tax

a. 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 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 the wife's estate could absorb the $2 million credit shelter trust without the imposition of any federal estate tax which would result in the assets of the credit shelter trust getting a step up in basis upon wife's death.

For income tax planning purposes it would be beneficial for the credit shelter trust assets to be includable in wife's estate upon her death so as to achieve a step up in basis. It may be desirable through a NJSA or other modification technique to grant wife a testamentary general power of appointment over the credit shelter trust so as to cause the assets of the credit shelter trust to be includable in the wife's estate for federal estate tax purposes.

b. Conversion of Trust from Grantor Trust to Non-Grantor Trust

The existing trust may be structured as a grantor trust for federal income tax purposes. Due to a change in circumstances the grantor may no longer be in a position where he or she desires, or is able, to pay the income tax liability associated with the trust's income being includable in the grantor's gross income and the trust may not contain a provision which would allow the trust to be converted into a non-grantor trust for income tax purposes. It

may be possible to convert the grantor trust into a non-grantor trust through a NJSA or similar technique.

c. Dual Grantor Trust

The existing trust may have dual grantors for federal income tax purposes. This structure may no longer work as the result of a divorce or death of one of the spouses.

d. Avoidance of State Income Tax

Under certain jurisdiction's laws income and capital gain that are accumulated in trust for beneficiaries that reside outside of that particular jurisdiction are not subject to state income tax in that particular jurisdiction. This creates the possible opportunity to avoid the imposition of state income tax.

It may be desirable to move a trust being administered in a jurisdiction with high income tax rates to another jurisdiction so as to avoid the imposition of state income tax. However, the terms of the existing trust may lack the flexibility needed to allow the situs and place of administration of the trust to be changed.

2. GST and Estate Tax

a. Extending Duration of a Trust

The terms of the existing trust may provide that upon the death of the current beneficiary the remaining trust assets are to be distributed outright and free of trust to the beneficiary's children. The beneficiary may want to extend the duration of the trust by preventing the assets from being distributed to his or her children upon the beneficiary's death for both creditor protection and tax planning purposes.

b. Avoiding Estate Tax Inclusion

The existing trust may be drafted in such way where it grants the current beneficiary certain powers that would result in the trust assets being includable in the beneficiary's estate for federal estate tax purposes. It may be desirable to modify the existing trust in such a way so as to prevent the inclusion of the trust assets in the beneficiary's estate.

c. Mixed Inclusion Trust

The existing trust may have a mixed inclusion ratio for GST purposes. It may be desirable to sever the existing trust into two separate trusts, one with an inclusion ratio of zero (0) and one with an inclusion ratio of one (1).

D. Other reasons why trusts become stale

1. Changes in the Law

In many situations the existing trust may contain provisions which were consistent with the grantor's intent at the time the trust was created but due to a change in the law such provisions no longer accomplish the desired goal. For example, the grantor may have intended for only natural born children to benefit from the trust. However, due to a change in law defining the term children or descendants the terms of the existing trust may no longer comply with the grantor's intent.

2. Drafting Errors

The terms of the existing trust may not comply with the grantor's intent due to a scrivener's error. It may be possible to enter into a NJSA to correct the scrivener's error and bring the trust into compliance with the grantor's intent

II. Strategies to Modernize and Modify Trusts

A. Nonjudicial Settlement Agreements and Nonjudicial Modifications

1. Overview of Modification

A trust modification does not change the terms of the governing instrument as of the date of trust execution. Instead a modification modifies the provisions of the trust moving forward.

Typically trust modifications are used to amend the administrative provisions of the trust. However, in certain situations they may also be used to modify the dispositive provisions of the trust.

2. Modification Under the Uniform Trust Code

A version of the Uniform Trust Code is now the law in thirty-six (36) states. The Uniform Trust Code contains several provisions permitting the modification of irrevocable trusts.

a. Relevant Sections of Uniform Trust Code

(1) Section 411 of the Uniform Trust Code

Section 411 of the Uniform Trust Code permits a non-charitable irrevocable trust to be modified or terminated upon consent of the Settlor and all of the beneficiaries, even if a modification or termination is inconsistent with the material purpose of the trust. The Uniform Trust Code permits the Settlor's consent to be given by the Settlor's agent, such as an attorney-in-fact.

Even if the Settlor is alive but unwilling or unable to consent to a modification or termination of the trust the Uniform Trust Code still provides a mechanism for such trust to be modified or terminated. Under Section 411(b) of the Uniform Trust Code a noncharitable irrevocable trust may be terminated or modified upon the consent of all of the beneficiaries if a court concludes that the continuance of the trust (or the modification of the trust) is not inconsistent with the material purpose of the trust.

(2) Section 412 of the Uniform Trust Code

Section 412 of the Uniform Trust Code permits a court to modify the administrative or dispositive provisions of a trust if, because of circumstances not anticipated by the Settlor modification or termination will further the purposes of the trust. Section 412 of the Uniform Trust Code contains a caveat that any such modification must be made in accordance with the Settlor's probable intention.

(3) Section 414 of the Uniform Trust Code

Section 414 of the Uniform Trust Code provides a mechanism to permit a trustee to terminate a trust that is no longer economical to administer. For purposes of the Uniform Trust Code the trust property must have a value of less than $50,000. The trustee is required to inform the qualified beneficiaries of its decision to terminate the trust.

(4) Section 416 of the Uniform Trust Code

Section 416 of the Uniform Trust Code permits a court to modify the terms of the trust in a manner that is not contrary to the Settlor's probable intent to achieve the Settlor's tax objectives. Section 416 of the Uniform Trust Code specifically permits the court to provide that the modification has a retroactive effect.

(5) Section 410 of the Uniform Trust Code

Section 410 of the Uniform Trust Code sets forth the mechanism pursuant to which the modification or termination otherwise permitted pursuant to Sections 411 through 416 of the Uniform Trust Code may be judicially approved or disapproved.

Such an action may be commenced by a trustee or beneficiary. Furthermore, a proceeding to approve or disapprove a proposed modification or termination may also be commenced by the Settlor if the Settlor is living.

(6) Section 111 Nonjudicial Settlement Agreements

Section 111 of the Uniform Trust code permits interested persons to enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust provided such nonjudicial settlement agreement does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court. For purposes of a nonjudicial settlement agreement the term "interested persons" means persons whose consent could be required in order to achieve a binding settlement or the settlement to be approved by a court.

Matters that may be resolved by a nonjudicial settlement agreement include, but are not limited to:

- The interpretation or construction of the terms of the trust;
- The approval of the trustee's report or accounting;
- Direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power;
- The resignation or appointment of a trustee and the determination of the trustee's compensation;
- Transfer of a trust's principal place of administration; and
- Liability of the trustee for any action relating to the trust.

Section 111(e) of the Uniform Trust Code permits any interested person to request the court to approve a nonjudicial settlement agreement, to determine whether the interested persons were properly represented and to determine whether the nonjudicial settlement agreement contains terms and conditions that the court could have properly approved.

3. Judicial Modification

In addition to the nonjudicial methods available to modify trusts, it is also possible to petition a court in the appropriate jurisdiction for a trust modification. Typically such modification actions

are brought to modify the administrative provisions of a trust but they also may be used to modify the dispositive provisions

B. Decanting

1. Overview of Decanting

The word decant means to pour a liquid from one vessel to another. In the trust context, the liquid is the trust assets and the vessels are the trust instruments.

Under the common law of certain jurisdictions, a trustee who has the ability to distribute principal outright from a trust to or for a beneficiary may instead exercise such authority by distributing the assets in further trust for the beneficiary. Phipps v. Palm Beach Trust Company, 142 Fla. 782 (1940); Wiedenmayer v. Johnson, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969), In re: Estate of Spencer, 232 N.W.2d 491 (Iowa 1975). Several states have codified the common law concept of decanting.

In 1992, New York became the first state to enact a decanting statute specifically authorizing a trustee in certain situations to pour the principal of one irrevocable trust into another trust. NY Estates, Powers & Trust Law § 10-6.6(b). Many states have enacted some version of a decanting statute.

In addition, the Uniform State Laws Commission approved the Uniform Trust Decanting Act. The Uniform Trust Decanting Act contains several safe guards for fiduciaries exercising their discretion to decant and also contains innovations not seen in some of the other state decanting statutes.

The various state statutes that permit a trustee to exercise a decanting power vary in their details but all operate off of the same fundamental premise. If a trustee has the ability to invade principal for a beneficiary under the terms of a trust agreement, the trustee may, in the exercise of its principal invasion power, appoint the principal to a new trust for the benefit of some or all 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.

2. 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.

a. 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, some states 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. Other states require the trustee to have an absolute power to invade principal which is not limited pursuant to an ascertainable standard.

Certain states, such as South Dakota and Delaware, permit a trustee to decant income from one trust to another even without the ability to invade trust principal. However, in such a situation only the income (and not the principal) could be distributed 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). 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. 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.

b. 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.

c. Elimination of Beneficiary's 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)(3).

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).

d. 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.

e. 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 situsted 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).

f. Implication of *Peierls* Decisions on Decanting

The Delaware Supreme Court 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. The governing law and place of administration holdings contained in the Peierls opinions were codified in Delaware. 12 Del. C. § 3332 and 12 Del. C. § 3340. The Peierls holdings open the door for the use of nonjudicial methods to modify trusts, such as a NJSA or 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. Merger

1. Overview of Merger

Many states have enacted state statutes allowing for trust mergers without judicial involvement, and other states mergers via the state's common law. The various state merger

statutes differ in their application but permit a trustee to merge the assets of one trust into another trust.

2. Requirements for Use of Merger

Typically a trustee may not merge the assets of one trust into another trust if doing so would have an impact on the beneficial interest of any of the trust beneficiaries. As such, mergers are not commonly used to change the beneficial interest of the trust beneficiaries. Some states are more liberal in their application of the merger statute and would allow a merger to change the beneficial interest of a trust beneficiary as long as such change does not constitute a material change in the beneficial interest of the trust beneficiaries or otherwise violate a material purpose of the trust. Delaware's merger statute expressly allows the trustee to create a second trust into which the assets of the first trust are merged into solely for purposes of the merger. 12 Del. C. § 3325(29).

D. Division

While a merger involves combining one or more trusts, a division involves dividing an existing trust into two or more separate trusts. There are both tax and non-tax reasons as to why it may be desirable to divide one trust into two or more separate trusts.

From a tax planning standpoint, it may be desirable to divide a trust for generation-skipping transfer tax planning purposes or marital deduction planning purposes. For example, a trust may have a mixed inclusion ration for generation-skipping transfer tax purposes and a division may be desirable to divide the trust into separate trusts, one with an inclusion ration of zero (0) and one with an inclusion ration of one (1).

Dividing a trust into multiple trusts may also be beneficial from an income tax reporting standpoint. For example, multiple grantors may have contributed property to one trust which could cause complexities in reporting the taxable income from the trust. It may be desirable to divide the trust into separate trusts so that each separate trust contains the assets contributed by a particular grantor.

From a non-tax planning perspective it may also be desirable to divide a trust to as to allow for different fiduciaries to serve for the divided trust. For example, a pot trust may have been created for the benefit of brother and sister with a corporate trustee serving for the trust. If the trust were divided into two separate trusts (one for brother and one for sister) it would be possible to allow a different corporate trustee to serve for each trust which may be beneficial to the trust beneficiaries.

E. Reformation

1. Overview of Reformation

A reformation is different than a modification. A reformation action would normally relate back to the date of trust execution whereas a trust modification modifies the provisions of the trust moving forward after the modification occurs.

Typically a reformation proceeding is one in which a court is faced with unambiguous language that does not accomplish what the court concludes that the Settlor intended. In other words, the provisions of the trust instrument are clear and do not need to be interpreted, however, such provisions do not comply with the Settlor's intent.

Reformation actions can typically be broken into three categories. The first category fixes a mistake that was made by the drafting attorney (i.e. scrivener's error) so that the trust instrument accurately reflects the Settlor's original intent in creating the trust. The second category reforms the trust not based on a drafting error, but instead based on what a court believes the Settlor would have wanted to achieve had the Settlor been aware of certain circumstances or certain laws that were in existence when he or she originally executed the instrument. The third category of reformation actions changes the provisions of the governing instrument in a way the court believes that Settlor would have wanted if he or she would have been able to predict a change in circumstances or a change in law that would result after the execution of the trust instrument.

2. Requirements for Reformation

A reformation action is a judicial action that will be brought in the court then having jurisdiction over the trust. In order to reform a trust, all beneficiaries whose interest would be affected must be a party to the action or otherwise notified of the court proceeding. In many situations it would be necessary for minor and unborn beneficiaries to be represented by a guardian ad litem unless such beneficiaries' interests can be virtually represented in accordance with the particular jurisdiction's virtual representation statute.

If the Settlor is living then the Settlor must be a party to the reformation action. Furthermore, it is typically necessary for the Settlor to execute an affidavit providing that the reformation is necessary to carry out the Settlor's intent in creating the trust.

In situations where the trust is being reformed to correct a scrivener's error the drafting attorney usually must also participate in the reformation action. Typically the drafting attorney will be required to execute an affidavit indicating that due to a mistake made by such attorney the terms of the trust instrument do not comply with the Settlor's intent.

III. Potential Tax Consequences of Modernizing and Modifying Trusts

The modification of an irrevocable trust through the use of any of the methods outlined in this article could result in potential negative tax implications. This is particularly true where the beneficial provisions of the trust are being modified. While any of the potential modification methods could result in negative tax consequences practitioners have been focusing on the potential tax consequences associated with the modification to a trust via a decanting. Provided below are the tax issues that should be considered when modifying a trust through a decanting or some other method.

A. Overview of 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 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 ACTEC and the ABA filed responses to IRS Notice 2011-101. Provided below is a list of the tax issues the IRS requested comments on:

B. Income Tax Considerations

1. 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.

2. 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").

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

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

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

C. Gift and Estate Tax Considerations

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

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

3. 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.

4. Whether a beneficiary who consents to a decanting (either voluntarily or as a condition of the decanting) or acquiescences in the decanting has made a taxable gift.

D. GST Tax Considerations

1. Whether a trust that has, by a decanting, received property from another trust that is a grandfathered trust for GST purposes continues to maintain its grandfathered trust status.

2. Whether decanted trust property that has an inclusion ratio of zero (0) or less than one (1), will have the same inclusion ratio in the trust receiving the decanted property.

3. Whether a trust that is not exempt from GST tax may be decanted so as to permit effective allocation of GST exemption to only a portion of the original trust.

The notice also seeks guidance (i) in how "decanting" should be defined, (ii) whether there should be additional tax consequences if the decanting is from a U.S. trust to a foreign trust or vice versa and (iii) whether a new Employer Identification Number should be required where all of the principal of the Trust is distributed to another trust.

E. Income Tax Considerations

1. Grantor Trust issues

IRC § 674(a) provides that a trust will be treated as a grantor trust for income tax purposes if the income or principal of the trust is subject to a power of disposition by any person without the consent of an adverse party. There are several exceptions to the adverse party rule. However, none of the exceptions apply if any person has the power to add a beneficiary to the trust.

A question that arises in a decanting is whether the new trust into which the assets of the old trust are decanted is considered a beneficiary. If so, the trust could fail to qualify for the exceptions under IRC § 674 because the trustee of the original trust would be treated as holding the power to add a beneficiary to the original trust.

The term beneficiary or beneficiaries for purposes of IRC §674 should be limited to the persons for whose benefit the trust is held and not the trust itself. The power to distribute trust property to another trust via the decanting should not disqualify the trust from the exceptions to IRC § 674(a) as long as the decanting power does not permit the new trust to include persons as beneficiaries that were not beneficiaries of the original trust.

Delaware's decanting statute specifically provides that the beneficiaries of the new trust must also be beneficiaries of the original trust. 12 Del. C. § 3528(a)(1). Therefore, Delaware's decanting statute prohibits beneficiaries to be directly added to the trust via the decanting. The addition of beneficiaries is also prohibited under the other state decanting statutes. Delaware's decanting statute does, however, permit the new trust to grant beneficiaries of the existing trust powers of appointment not otherwise set forth in the original trust, which can indirectly lead to the addition of new beneficiaries not present in either the original or the new trust pursuant to the beneficiary's exercise of the power of appointment. 12 Del. C. § 3528(a).

2. Identity of the Settlor of the Second Trust.

Another issue that may arise when property is decanted from one trust to another trust is determining who the "grantor" of the second trust is for income tax purposes. If the second trust is viewed as a continuation of the first trust, then the same person should be considered to be the grantor of both the first and the second trust.

The Illinois decanting statute specifically addresses the identity of the grantor of the second trust by providing that the grantor of the first trust is considered "for all purposes" to be the grantor of any second trust established pursuant to the statute. 760 ILCS 5/§ 16.4(t). If the second trust has other assets, then the grantor of the first trust is considered the grantor of the second trust only with respect to the assets that are actually transferred from the first trust to the second trust. Id.

The Illinois statute is consistent with the Treasury Regulations. Treas. Reg. § 1.671-2(e)(5) provides that if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.

An exception arises where property is distributed from the first trust to the second trust pursuant to the exercise of a general power of appointment. In such a case, the person exercising the power of appointment will be treated as the grantor of the second trust.

3. DNI and Transfer of Tax Attributes

It is possible through a decanting to decant all of the assets of the original trust into the new trust or only a portion of the assets of the original trust into the new trust. There appears to be a difference of opinion as to whether in a complete decanting the new trust is a continuation of the old trust and should therefore continue to operate under the old trust's employer identification number or whether the new trust should obtain a new employer identification number. There are Private Letter Rulings which suggest that the new trust is merely a continuation of the old trust. PLR 200607015 and PLR 200736002.

IRC § 661 permits a trust to deduct in the calculation of its taxable income distributions the trust is required to make and distributions actually made that are permitted distributions. IRC § 662 requires beneficiaries who receive distributions to include such amount in their gross incomes for the year.

The Code does not specifically include a trust which can receive distributions from another trust within the definition of beneficiary for purposes of IRC §§ 661 and 662. However, case law suggests that one trust can be a beneficiary of another trust for purposes of IRC §§ 661 and 662. Lynchburg Trust and Savings Bank v. Commissioner, 68 F.2d 356 (4th Cir. 1934); Duke v. Commissioner, 38 BTA 1265 (1938).

In a situation where all of the assets are decanted from the original trust to the new trust the tax attributes from the original trust should be carried over to the new trust. IRC § 642(h) provides that in the final year of a trust, its capital loss and net operating loss carry forward and its deductions in excess of gross income for the year will be allowed as deductions to the beneficiaries who receive the trust property. In either case, the tax attributes from the original trust should carry over to the new trust.

The Uniform Trust Decanting Act and Delaware's decanting statute both permit the exercise of the decanting power so as to decant the assets of the existing trust back into the same trust, as modified, pursuant to the decanting. Utilizing this provision resolves any issue associated with whether a decanting results in the establishment of a new trust as the existing trust remains in effect but modified pursuant to the decanting. This provision essentially allows the decanting to act as a modification technique to an existing trust.

4. Recognition of Gain

As a general rule the distribution of appreciated assets from one trust to another trust pursuant to a decanting should not result in recognition of gain to the trust or any of the trust beneficiaries. At the trust level, if a distribution of appreciated assets is made from one trust to another trust, IRC § 643(e) would protect the distributing trust from recognizing gain unless the trustee of the distributing trust elects to recognize the gain.

IRC § 662(a) provides that a beneficiary may experience income by reason of a trust distribution only to the extent of the trust DNI. In a decanting the DNI from the original trust is not being distributed to the beneficiary. If anything, the DNI is being distributed to the new trust.

One area of possible caution is where the decanted property includes negative basis assets, such as property with debt in excess of basis or is a partnership or limited liability company interest with a negative capital account. In such a case, gain may be triggered under the authority of Crane v. Commissioner, 331 U.S. 1 (1947). It is not clear if Crane applies to a distribution from a non-grantor trust. IRC § 643(e) provides that gain generally is not recognized on a distribution of appreciated property from a non-grantor trust.[1] Whether Crane trumps IRC § 643(e) is not clear. However, regardless of whether Crane trumps IRC § 643(e), if all of the assets of a first trust are distributed to a second trust that is considered to be a continuation of the first trust, or if both the first trust and the second trust are grantor trusts deemed owned by the same person, no gain should be recognized on the distribution.

F. Gift and Estate Tax Considerations

1. Beneficiary's Consent to Decanting

It is possible through a decanting to reduce, or in some cases eliminate, a beneficiary's interest in the original trust. 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. 12 Del. C. § 3528(a)(3). Delaware's decanting statute can also be used to eliminate a beneficiary's power to withdrawal trust assets provided such power is not presently exercisable. 12 Del. C. § 3528(a)(4). An issue that arises is whether a beneficiary has made a taxable gift to the new trust when the beneficiary's interest in the old trust is reduced pursuant to the decanting.

In order for a gift to occur there must be an act of transfer. In the decanting context a beneficiary is not affecting the transfer of the assets from the original trust to the new trust.

[1] Code § 643(e) does not apply where the first trust is a grantor trust. Where property encumbered with debt in excess of basis or a partnership or LLC interest with a negative capital account is transferred from a grantor trust to a non-grantor trust or to a grantor trust deemed owned by a different person, gain may be recognized under *Crane*.

The trustee causes the transfer of the assets from the original trust to the new trust. The beneficiary therefore should not be treated as having made a taxable gift when a trustee exercises the decanting power to reduce the beneficiary's interest in the trust unless the beneficiary has a legal right to object to the exercise of the authority to decant. Under Delaware's decanting statute it is not necessary to obtain a beneficiary's consent to decant the trust assets or even to notify the beneficiary of the decanting. The beneficiary's mere acquiescence to the decanting should not rise to the level of a taxable gift.

A more difficult issue involves whether the beneficiary's consent to a decanting which eliminates or reduces a beneficiary's interest in the old trust rises to the level of a taxable gift. For instance, assume the terms of the governing instrument permit the trustee to distribute income and principal to A for any purpose and provide that upon attaining the age of thirty-five (35) all of the assets are to be distributed outright and free of trust to A. Further assume that the trustee decants all of the assets to a new trust which extinguishes the trustee's requirement to distribute the remaining trust assets to A upon her attaining the age of thirty-five (35) and instead provides that all of the trust assets shall remain in further trust for A's lifetime.

If A consents to the decanting, the IRS could argue that A's right to receive the assets upon attaining the age of thirty-five (35) is equivalent to a general power of appointment and A's consent to the decanting is a lapse or release of a general power of appointment. This would result in the new trust becoming a self-settled trust with respect to A either upon the decanting or upon A attaining the age of thirty-five (35).

In 2023, the IRS issued an opinion relating to the gift tax consequences of modifying an irrevocable grantor trust to add a tax reimbursement clause. CCA 2002352018 (the "CCA").

In the trust at issue in the CCA, a grantor established an irrevocable inter vivos trust in Year 1 for the benefit of the grantor's Child and the Child's descendants. The grantor retained a power that caused the grantor to be treated as the owner of the trust for income tax purposes. The trust provided that the Trustee of the trust had absolute discretion to distribute income and principal to or for the benefit of Child. Upon Child's death, the trust's remainder is to be distributed to the Child's issue, per stirpes.

In Year 2, the Trustee petitioned State Court to modify the terms of the trust to provide the Trustee with the discretionary power to reimburse the grantor for any income taxes the grantor pays as a result of the inclusion of the trust in the grantor's taxable income. The Child and the Child's issue consented to the modification. The Child had no living grandchildren or more remote descendants at the time. The State Court granted the petition and issued an Order modifying the trust accordingly.

The IRS determined that the modification of the trust to add the tax reimbursement clause constituted a taxable gift by the trust beneficiaries. The addition of the discretionary tax reimbursement power is a relinquishment of a portion of the beneficiaries' interest in the trust. The IRS further determined that this result would be same if the modification occurred pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object.

If the Grantor consents to the decanting, or provides the decanting trustee with a release and/or indemnification, the IRS could argue that the grantor retained substantial control over the trust assets under IRC §§ 2036 or 2038 in an attempt to include the trust assets in the grantor's estate.

2. Trustee/Beneficiary

In certain situations a beneficiary may be serving as a co-trustee of the trust and participate in the decanting. Typically if a beneficiary is serving as a trustee, the trustee will be restricted in how the trust assets may be distributed to the beneficiary. For instance, the trustee/beneficiary will only be permitted to distribute trust assets to the trustee/beneficiary for his or her health, education, maintenance and support. A distribution in further trust which continues to restrict how the assets may be utilized for such beneficiary should not result in any negative gift tax consequences to the trustee/beneficiary.

Delaware law makes it clear that the trustee's exercise of the decanting power must comply with any standard imposed by the first trust. 12 Del. C. § 3528(a). If a trustee is constrained in making distributions pursuant to an ascertainable standard under the terms of the first trust, the new trust must also limit distributions pursuant to an ascertainable standard.

3. Marital Deduction Trusts

Another question that arises in a decanting is whether a decanting power contained in a trust that qualifies for the marital deduction under IRC §§ 2523 or 2056 causes the trust to fail to qualify for the marital deduction. The question is whether the trustee could exercise the decanting power to distribute assets from the original trust that qualifies for the marital deduction into a new trust that would not qualify for the marital deduction.

If the authority to decant is held in a fiduciary capacity it would seem that the terms of the trust or applicable law governing the trust would prohibit the fiduciary from exercising a power over the original trust in a manner that would be adverse to the interest of the beneficiaries or violate a material purpose of the trust. It would seem that the fiduciary could not then exercise the power to decant into a trust that does not qualify for the marital deduction because doing so would not be in the best interest of the beneficiaries of the trust. Delaware's statute makes

it clear that a trustee may not exercise its decanting power over a trust that qualifies for the marital deduction to distribute the assets of such trust into a new trust that reduces any income interest of any income beneficiary of such trust. 12 Del. C. § 3528(a)(3).

4. Estate Tax

As a general matter, no adverse federal estate tax consequences should arise as a result of the decanting. As previously mentioned, Delaware's decanting statute permits a decanting to grant a beneficiary of the original trust with a power of appointment not otherwise contained in the original trust. This power of appointment may be a general power of appointment or a limited power of appointment. 12 Del. C. § 3528(a). To the extent the new trust grants a beneficiary of the original trust a general power of appointment, the assets would be includable in the beneficiary's estate upon his or her subsequent death.

5. The Delaware Tax Trap

IRC § 2041(a)(3) and its gift tax counterpart, IRC § 2514(d), are known as "the Delaware Tax Trap." The Delaware Tax Trap applies where the holder of a limited power of appointment (the "first power") exercises the power by creating another power (the "second power") that under applicable local law can be validly exercised so as to postpone the vesting of the trust property or suspend the absolute ownership or power of alienation of such property for a period ascertainable without regard to the date of creation of the first power.

In such a case (i) the holder's exercise of the first power will be deemed a transfer subject to gift tax under IRC § 2514(d) (this is the case regardless of whether the second power is exercised) and (ii) the property subject to the decedent's exercise of the first power will be includable in the decedent's gross estate for estate tax purposes under IRC § 2041(a)(3) (which treats the decedent's exercise of a limited power of appointment as if it were the exercise of a general power of appointment).

The key to springing the Delaware Tax Trap is the exercise of the first power to create a second power that has the effect of postponing the period of the rule against perpetuities applicable to the trust that created the first power. This results in the conversion of the non-general power of appointment into a taxable general power.

As previously noted, a number of state decanting statutes, including Delaware's decanting statute, permit the second trust to grant a power of appointment to a trust beneficiary. The question is whether this will this trigger a taxable gift if the vesting period does not relate back to the perpetuities period applicable to the first trust. Most commentators believe the Delaware Tax Trap rules were designed to apply to beneficiary powers of appointment, not fiduciary powers of appointment.

Where the second trust grants a beneficiary a limited power of appointment and the beneficiary exercises that power in further trust during his lifetime to create another power that can extend the perpetuities period applicable to the second trust, the beneficiary's exercise of the power would constitute a taxable gift under IRC § 2514(d). Similarly, if the beneficiary of the second trust is granted a testamentary limited power of appointment and exercises that power, in further trust, by creating another power that can delay the vesting of trust property beyond the perpetuities period applicable to the second trust, the property subject to the exercise of the power will be included in the beneficiary's estate under IRC § 2041(a)(3).

To avoid the application of the Delaware Tax Trap in Delaware, the Delaware Legislature enacted 25 Del. C. § 504 in 2000. The statute provides that in the case of a limited power of appointment over property held in trust (the "first power"), if the trust is not subject to the generation-skipping transfer tax, or has an inclusion ratio of zero for purposes of the generation-skipping transfer tax, then every estate or interest in property, real or personal, created through the exercise, by Will, deed or other instrument, shall be deemed to have been created at the time of the creation of, and not at the time of the exercise of, the first power.

Delaware's decanting statute provides that the use of the statute to decant shall be considered the exercise of a limited power of appointment and shall be subject to the provisions of Chapter 5 of Title 25 of the Delaware Code concerning the time at which the permissible period of the rule against perpetuities begins and the law which determines the permissible period of the rule against perpetuities. 12 Del. C. § 3528(c). Therefore, the trustees' exercise of their authority under Delaware's decanting statute to decant assets into new trusts is treated as the exercise of a limited power of appointment.

Delaware law would prevent a decanting which occurs in accordance with the Delaware statute from springing the Delaware Tax Trap with respect to a generation-skipping transfer tax exempt trust. Under Delaware law a limited power of appointment over a generation-skipping transfer tax exempt trust cannot be exercised without relating back to the creation of the first power thereby prohibiting the application of the Delaware Tax Trap.

G. GST Tax Considerations

1. GST Exempt Status of a Trust

Trusts can be exempt from GST tax in two ways: (1) per Treas. Reg. § 26.2601-1(b), a trust is exempt from GST tax if it is a "grandfathered trust" meaning, generally, that it became irrevocable on or before September 25, 1985 (which is the effective date of the GST Code sections); or (2) the transferor allocated GST exemption to the trust (such trusts are also sometimes referred to as "non-grandfathered trusts" or "zero inclusion ratio trusts").

Treas. Reg. § 26.2601-1(b)(1) provides that a trust can lose GST exempt status if an actual or constructive addition is made to the trust after the effective date. With respect to decanting, the concern is that the decanting may be viewed as an addition or modification to a trust that causes it to lose its GST exempt status.

Interestingly, the Treasury Regulations provide a set of rules and "safe harbors" for grandfathered trusts in order to ensure that a decanting or modification of a grandfathered trust does not jeopardize its GST exempt status, but currently there are no rules or safe harbors specifically relating to non-grandfathered trusts.

2. Decanting as the Exercise of a Limited Power of Appointment

Many states that have adopted decanting statutes, treat the trustee's power to decant as the exercise of a limited power of appointment. Delaware's decanting statute specifically notes that the exercise of a trustee's decanting power shall be considered to be the exercise of a limited power of appointment. 12 Del. C. § 3528(c).

There is a specific Treasury Regulation that deals with the effect of the exercise of a limited power of appointment over the assets of a grandfathered trust. Treas. Reg. § 26.2601-1(b)(1)(v)(B) provides that the exercise of a limited power of appointment over the assets of a grandfathered trust will not cause a trust to lose its GST exempt status unless the exercise of the power of appointment violates the federal perpetuities period.

For purposes of this Treasury Regulation, the permissible perpetuities period under federal law will not be deemed to violated as long as the vesting or absolute ownership of an interest in trust property is not delayed beyond: (1) a life in being when the trust was created plus 21 years; or (2) 90 years from the date of the creation of the trust.

Thus, Treas. Reg. § 26.2601-1(b)(1)(v)(B) would lead us to believe that if decanting is deemed to be the equivalent of exercising a limited power of appointment, then as long as the vesting of beneficial interests in the "decantee trust" (i.e., the trust to which the assets of the original trust are distributed) is within the proscribed perpetuities period, the decantee trust can differ substantively from the original trust without loss of GST exempt status.

Unfortunately, regardless of how Delaware (or other states) may treat the power to decant, the IRS concluded in PLRs 9848043 and 9849007 that Treas. Reg. § 26-2601-1(b)(1)(v)(B) was not directly relevant when considering a trustee's decanting power under a state statute requiring the participation or concurrence by the court and/or the trust beneficiaries. This is unfortunate because, as we will see, Treas. Reg. § 26-2601-1(b)(1)(v)(B) would allow for

broader changes in the new trust than allowed under the safe harbors contained in the other relevant Treasury Regulations.

3. The "Discretionary Distribution" Safe Harbor for Grandfathered Trusts

Treas. Reg. 26.2601-1(b)(4)(i)(A) is sometimes known as the "discretionary distribution" safe harbor and provides guidelines for determining when the distribution of trust assets from a grandfathered trust to a new trust could cause the loss of GST exempt status.

The discretionary distribution safe harbor essentially provides that decanting will not cause a grandfathered trust to lose GST exempt status if the following three requirements are met:

a. When the trust became irrevocable, either the terms of the trust instrument or local law (i.e., a statute or common law) authorized the trustee to distribute trust property to a new trust;

b. Neither beneficiary consent nor court approval is required for the trustee's exercise of such power; and

c. The new trust will not delay the vesting of an interest in the trust beyond the permissible perpetuities period under federal law. For purposes of this Treasury Regulation, the federal perpetuities period is (1) a life in being when the trust became irrevocable plus 21 years; or (2) 90 years from the date the trust became irrevocable.

The first requirement of the discretionary distribution safe harbor is particularly interesting because no state had a decanting statute at the time of the effective date of the GST tax in 1985. As such, in order to comply with the discretionary distribution safe harbor, if the terms of the trust do not authorize distribution to a new trust, you would need to rely on the common law of the state in which the trust is located to authorize the decanting. Some commentators suggest that most, if not all, states authorize decanting via common law principles, but only the courts of Florida, New Jersey and Iowa have explicitly recognized a common law authority to decant.

The second requirement does not appear to prohibit a trustee from obtaining beneficiary consent or court approval of the decanting. Delaware's decanting statute does not require beneficiary consent or court approval for the trustee's exercise of its decanting power, although the trustee and other parties involved may choose to obtain beneficiary consent or court approval before decanting to a new trust.

With respect to the third requirement, when utilizing Delaware's decanting statute to decant the assets of a grandfathered trust, the attorney drafting the decantee trust (or the trust officer reviewing such trust on behalf of the trustee) should be as careful as possible to ensure that the

new trust contains a provision limiting the vesting period to comply with the federal perpetuities period described in the Treasury Regulations.

Under the discretionary distribution safe harbor, what changes can be made without jeopardizing the trust's GST exempt status? If decanting only changes administrative terms of the trust, there should be no loss of GST exempt status (PLR 200607015). However, it is important to consider what provisions are merely administrative in nature and what changes may be viewed as affecting the substantive or beneficial terms of the trust.

4. The "Trust Modification" safe Harbor for Grandfathered Trusts

Treas. Reg. § 26-2601-1(b)(4)(i)(D) is sometimes known as the "trust modification" safe harbor. The trust modification safe harbor is seen as a "catch-all" that applies when all of the requirements set forth in the discretionary distribution safe harbor cannot be met.

The trust modification safe harbor provides that a modification to a grandfathered trust will not cause loss of GST exempt status as long as:

a. The modification will not shift a beneficial interest in the trust to a beneficiary occupying a lower generation than the persons holding the beneficial interest in the original trust; and

b. The modification will not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Regarding the first requirement, note that beneficial interests can be shifted across the same generational level or to a higher generational level than the persons holding the interest in the original trust. However, it is important to be extremely careful when shifting beneficial interests, because the Treasury Regulations and their attendant examples provide that if a trust modification results in either an increase in the amount of a GST transfer or creates a new GST transfer, there is deemed to be a shift in a beneficial interest to a lower generation beneficiary. Additionally, if the effect of a modification cannot be determined immediately after the modification is made, there is a deemed to be a shift in a beneficial interest to a lower generation.

5. Non-Grandfathered Trusts

There are no Code sections or Treasury Regulations that deal directly with the decanting or modification of non-grandfathered trusts. However, the IRS suggested in PLR 200743028 that the Treasury Regulations applicable to grandfathered trusts should also apply to non-grandfathered trusts.

An interesting example would involve a trust to which the grantor allocated GST exemption after the state in which the trust is situsedenacted a decanting statute. If the Treasury Regulations that apply to grandfathered trusts also apply to this non-grandfathered trust, then presumably a Delaware trustee could decant pursuant to Delaware's decanting statute, and the decantee trust could shift beneficial interests in the trust to lower generations as long as no beneficiary consent or court approval is required (per the discretionary distribution safe harbor).

If the IRS ultimately decides that the GST Regulations for grandfathered trusts should not apply to non-grandfathered trusts (a result most commentators find unlikely), one could argue that Treas. Reg. § 26-2601-1(b)(1)(v)(B) relating to limited powers of appointment should apply.

6. Effect of Loss of GST Exempt Status

PLR 9522032 suggests that if a trust loses its GST exempt status, there are no immediate gift tax implications, but the grantor of the trust will become the transferor for GST tax purposes.

Logically, although there is no authority directly on point, the loss of GST exempt status should not result in all future distributions from the trust being subject to GST tax. A GST tax should only be imposed when a distribution is made to someone that could not have received a distribution from the original trust without being subject to GST tax.

IV. Protecting the Fiduciary in Trust Modifications

The potential liability a fiduciary faces for participating in a modification or modernization of a trust is in large part dependent on the method chosen to modify or modernize the trust. In certain jurisdictions a nonjudicial modification agreement can be entered into between the settlor and the beneficiaries without the involvement of the trustee. A nonjudicial settlement agreement would necessitate the participation of the trustee. Even if the trustee is required to participate in a NJSA or a nonjudicial modification agreement the trustee is one of many parties participating in such an agreement which could lessen any potential liability associated with the trustee or fiduciary exercising its discretion to participate in the agreement.

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 existing trust or otherwise engage in the decanting and who approach the trustee with the request. This can put the trustee in a difficult position in that the trustee wants to accomplish the beneficiary's goals but at the same time is concerned about the potential liability associated with the decanting.

For example, assume the trustee is approached by the senior generation beneficiaries of the trust about engaging in a decanting which would prevent the next generation beneficiaries from receiving information about the trust. The next generation beneficiaries could feel that they were economically harmed or damaged as a result of the trustee's exercise of its discretion and bring a breach of fiduciary duty action against the trustee as it was the trustee's sole discretion to enter into the trust to trust transfer to add the silent trust language.

There are certain options available to trustees to mitigate potential liability in trust to trust transfers.

A. Statute of Limitations

1. Time Period

A trustee that is concerned about potential liability in a decanting may decide to provide the beneficiaries with sufficient notice of the transaction so as to begin the statute of limitations for an aggrieved beneficiary bringing a breach of trust action against the trustee. Various states have differing statute of limitations periods that apply with respect to a possible breach of trust action. Under Delaware law, a beneficiary may initiate a proceeding against a trustee for breach of trust until the first to occur of one year after the date the beneficiary was sent a report that adequately disclosed the facts constituting a claim or the date the proceeding was otherwise precluded by adjudication, release, consent or limitation. 12 Del. C. § 3585(a)(1).

2. Information Required to Trigger Statute

Another issue for a trustee to consider is what information must be provided to the beneficiary in order for the statute of limitations period to begin. The trustee wants to ensure that sufficient information has been provided to the beneficiaries so that they are put on notice.

It is advisable that the trustee send the beneficiaries all pertinent information relating to the decanting so that that the beneficiaries have sufficient notice. For example, the trustee would want to provide the beneficiaries with a copy of the existing trust instrument, a copy of the new trust into which the assets will be decanted and possibly a summary explaining the differences between the existing trust and the new trust. The information provided to the beneficiary must adequately disclose the facts constituting a potential claim the beneficiary could have against the trustee.

3. Virtual Representation

Another difficult issue for trustees to consider is how to bind minor or unborn beneficiaries for purposes of triggering the applicable statute of limitations or otherwise entering into a consent, release and indemnity agreement which will be described in the following section of this

article. In certain states a trustee would need to petition to have a guardian ad litem appointed to represent the interest of the minor and unborn beneficiaries in order to either commence the statute of limitations for potential breach of fiduciary duty claim or otherwise have minor and unborn beneficiaries be bound pursuant to the terms of a consent, release and indemnity agreement.

However, other jurisdictions have virtual representation statutes which would permit an adult beneficiary to virtually represent the interest of the minor and unborn beneficiaries. The key to utilizing the virtual representation statute is to first identify the potential beneficiaries and ensure that the adult beneficiaries that are representing the interest of the minor and unborn beneficiaries have a similar interest. There are typically two requirements in order for the virtual representation statute to be applicable: (1) the person representing the minor or unborn beneficiary must have a substantially identical interest with respect to the particular question or dispute and (2) there must be no material conflict of interest between the minor or unborn beneficiary and the person representing such minor or unborn beneficiary.

In many situations it is easy to determine whether the adult beneficiary representing the interest of the minor beneficiary has a substantially identical interest in the trust. However, it could be more difficult to determine whether there is a conflict of interest between the minor or unborn beneficiary and the adult beneficiary representing the interest of the minor or unborn beneficiary.

For example, assume that pursuant to a NJSA the adult beneficiary representing the interest of the minor or unborn beneficiary will have the authority to remove and replace trustees of the modified trust but such adult beneficiary did not have the power to remove and replace trustees. It is quite possible that a court could determine there is a material conflict of interest between the adult beneficiary and the minor or unborn beneficiary as the adult beneficiary is garnering more power and authority over the trust pursuant to the NJSA. This would invalidate the use of the virtual representation statute for purposes of representing the minor and unborn beneficiaries.

B. Release Agreements

1. Consent, Release and Indemnity Agreements

It is typical for a trustee engaging in a trust modification to require that all of the interested parties execute a Consent, Release and Indemnity Agreement in connection with the modification. Pursuant to the Consent, Release and Indemnity Agreement the interested parties will consent to action, release the trustee from any potential liability in connection with the exercise of its discretion to engage in the modification and indemnify the trustee from any potential liability from engaging in the modification. Oftentimes the indemnity will be limited to actual distributions received by the beneficiaries.

Certain jurisdictions have codified this concept. For example, there is a consent, release and ratification statute under Delaware law. 12 Del. C. § 3588. Under Delaware law the Consent, Release and Indemnity Agreement is valid whether or not it is supported by consideration.

2. Tax Concerns

Another difficult issue trustees engaging in trust modifications or decanting face is whether to require beneficiaries to enter into a Consent, Release and Indemnity Agreement in connection with the decanting or modification if doing so could result in potential negative tax consequences to the beneficiaries. Under certain situations it is possible that the act of entering into the Consent, Release and Indemnity Agreement could have severe negative tax ramifications to the trust beneficiaries. This is particularly the case when a beneficiary's interest is potentially diminished pursuant to a decanting or modification.

For example, assume grandfather creates a trust for the benefit of his daughter and her two children (i.e. grandfather's grandchildren). The terms of the trust provide that distribution can be made in the discretion of the trustee to or for the benefit of daughter and grandchildren. Upon daughter's death the remaining trust assets will be distributed outright and free of trust to the grandchildren. Daughter approaches the trustee about engaging in a decanting which would result in the assets of the existing trust being distributed to a new trust that grants daughter a broad limited testamentary power of appointment.

The trustee's first reaction in such a situation would be to approach the existing beneficiaries of the trust and request that they execute a Consent, Release and Indemnity Agreement in connection with the decanting. However, the decanting has the potential of diminishing the beneficial interest of the grandchildren as daughter could exercise her testamentary limited power of appointment in such a way so as to appoint the assets away from the grandchildren. It is possible that the Internal Revenue Service could determine that by consenting to the dcanting the grandchildren have made a gift to the trust (even though difficult to value) because

they have given up their vested right to receive the remaining trust assets upon daughter's passing.

As mentioned earlier, the recent CCA 202352018, released on December 29, 2023, highlights the trustee's risk in modifying trusts that may have potential gift tax consequences. Under the facts of the CCA, the trustee petitioned the state court to modify the trust to include a provision to allow for the trustee, in its discretion, to reimburse the grantor for income taxes attributable to the trust. The child consented to the modification and the court granted the petition to modify the trust terms. The IRS took the position that such a modification constitutes a gratuitous transfer from the child to the grantor, and therefore, results in a taxable gift by the child (the beneficiary).

This CCA highlights the need for trustees to carefully engage in decanting, NJSAs and nonjudicial modification agreements as trustees must balance the grantor's wishes and intentions, all the beneficiaries' interests, and the potential tax implications to avoid unintended consequences. For example, a grantor is unable to support the tax burden due to a large liquidity event and he requests the trustee to engage in a decanting (or to modify the trust) to incorporate a trustee's power to reimburse the grantor for taxes paid by the grantor. What if one beneficiary is supportive while another beneficiary is not? There is an inherent tension between the duty to preserve trust assets for beneficiaries and the decision to distribute to the grantor to pay the grantor's income tax liability, and therefore, there are risks that trustees have when considering modifying trusts to add a tax reimbursement clause to the trust terms.

As stated, trustees typically want a Consent, Release and Indemnity Agreement from beneficiaries in connection with the decanting or modification. With the Consent, Release and Indemnity Agreement, the beneficiaries are informed of the changes being made, but are they advised of the potential tax consequences such modifications may have? Are trustees diligent in providing sufficient and transparent notice to beneficiaries? Recall that Delaware's decanting statute does not require beneficiary consent for the trustee's exercise of its decanting power. However, trustees may choose to obtain beneficiary consent because the consents provide assurance to the trustee that beneficiaries understand the changes being made and their potential impact. Furthermore, notice to beneficiaries is crucial for maintaining trust and preventing or mitigating future disputes and conflicts. It also begins the statute of limitations for any beneficiary who may want to bring a claim for breach of trust.

In some jurisdictions, trustees are legally required to notify beneficiaries of significant changes to trusts. This includes modifications that could affect distributions of assets or the tax liabilities of the beneficiaries. In fact, the IRS stated in the CCA that the modification would also result in a taxable gift by a beneficiary if the modification was made pursuant to a state statute that gives beneficiaries a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object. This means, if the state statute provides the

child with a right to notice and a right to object to the modification, and the child failed to exercise his right to object, the modification would be a taxable gift by the child. Not only should the trustee provide notice to the beneficiary, but also should disclose sufficient facts of the modification for the beneficiary to object or not to object.

Further difficulties and challenges arise when the trusts are quiet or silent trusts and beneficiaries are not even aware of the existence of the trust. In these cases, the trustee may consider alternative means or other solutions to achieving the goal. If the CCA imposes potential tax consequences to beneficiaries who do not know about the trust, the trustee may consider turning off grantor status of the trust or if the grantor's spouse is a permissible beneficiary, to make a distribution to the grantor's spouse. The trustee may also consider moving the trust to another jurisdiction that statutorily gives the trustee the discretionary power to reimbursement a grantor for their income tax liability attributable to the trust. Delaware codified this in 2019 giving the trustee sole discretion to reimburse a grantor or to pay an appropriate taxing authority on the grantor's behalf. 12 Del. C. § 3344.

If the grantor is living the trustee may also be inclined to have the grantor execute the Consent, Release and Indemnity Agreement to ensure that the exercise of the decanting power is not inconsistent with the grantor's intent in establishing the existing trust. However, this can cause potential estate tax consequences to the grantor as it could be determined that the grantor is participating in the decanting.

The CCA has highlighted the importance of not only understanding the tax implications of trust modifications, but also the risks that trustees have to consider.

C. Judicial Actions

1. Petition for Instruction

The trustee may be approached by a beneficiary about entering into a decanting or modification that the trustee is not certain is permitted by the terms of the existing trust instrument. The trustee could file a petition for instruction with the court then having jurisdiction over the trust to determine whether it would be an appropriate exercise of the trustee's discretion to engage in the decanting or modification. The benefit of filing such a petition for instruction is that it puts all of the interested parties on notice and in many cases the interested parties will be required to actually execute waiver instruments in connection with the petition.

2. Judicial Accounting

Another option for a trustee desiring to be absolved of any potential liability in connection with a decanting or modification is to file a judicial accounting with the court after the decanting or

modification has occurred which discloses the transfer. All of the beneficiaries of the trust will be provided with a copy of the accounting and have an opportunity to object to the accounting for a certain period of time. Under most jurisdiction's laws the expenses, including legal fees, associated with preparing and filing the judicial accounting is an appropriate expense of the trust.