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DECANTING, ANYONE?

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In the language of trusts, “decanting” means something very different from its wine connotation. For trusts, “decanting” describes the “pouring” or transfer of assets from the original trust or “bottle” into a second trust or “bottle” whose provisions better reflect the goals of the settlor. The assets or “wine” remain the same, but in the second trust, the provisions are “improved,” like aerated wine, for being updated.

In 1992 New York became the first state to permit decanting. Now in 2011, there are an additional nine states – Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, North Carolina, South Dakota, and Tennessee – that provide a statutory framework for the procedure. What is behind this interest in decanting?

In a word, the irrevocability of trusts created under a decedent’s governing instrument or inter-vivos irrevocable trusts. These trusts by their nature cannot be amended or revoked, yet they are not immune from the same problems that affect other trusts. Unfortunately, the solution is not easily accomplished.

Examining the decanting laws of Delaware and Nevada will illustrate this point.

Reasons for Change

Change can be broadly divided into administrative or dispositive categories. Perhaps a beneficiary is under a legal disability and would lose federal and government assistance if he or she received the funds outright as provided in the initial agreement. Perhaps a spouse dies before executing a new, completely different estate plan that will not parallel a surviving spouse’s new plan.

Many states have passed laws that streamline trust administration and make it more responsive to beneficiaries. These include flexible investment powers; better protection against creditors; lower state income taxes; and the ability to name advisors and trust protectors as a check on the corporate trustee.

Despite their similarities, there is a surprising degree of difference in fiduciary administrative provisions even between two states at the forefront of fiduciary innovation, Delaware and Nevada. Delaware, for example, releases the trustee from liability when it hires a third party for investment purposes in a fiduciary agency arrangement if the trustee exercises the “standard of care required of the fiduciary in making such decisions.” Nevada permits delegation by the trustee, “but the fiduciary is not thereby relieved of any liability that exists in the absence of delegation.” Some settlors want to keep the existence of a trust confidential. Delaware permits the limitation of notification to beneficiaries if the governing instrument specifically authorizes it, whereas Nevada is silent on beneficiary notification.

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Both Delaware and Nevada permit self-settled “asset protection trusts” that allow a settlor (grantor) to create an irrevocable trust from which he or she may receive benefits but which is protected from the settlor’s creditors if certain conditions are met. Both permit the settlor to enjoy certain access to the funds such as the right to direct the investments or the testamentary ability to appoint the trust among specified groups; however, Nevada permits the settlor to serve as trustee under certain conditions, but Delaware is silent on the point.

Consent Petitions

Prior to the passage of the decanting statute in 2003, trusts in Delaware could be changed by a consent petition submitted to the Court of Chancery by a fiduciary or anyone with a beneficial interest. The petition must meet the requirements set forth by the Register in Chancery, one of which requires the attachment of “Consents,” otherwise known as Notices of Nonobjection or Statements of No Position from all interested parties. If the Court of Chancery approves the petition, the trust is then reformed. The petitions are not a matter of public record, and since the actions of the Court of Chancery require no jury, are usually handled expeditiously.

Filing the petition is relatively easy; obtaining the unanimous, written consent of all beneficiaries can be difficult. And “all beneficiaries” include minors that are represented by a guardian ad litem, as well as unborn beneficiaries who are represented by Delaware’s virtual representation law. Other beneficial interests may be involved. Assuming that the trustee initiates the petition, its signature is not required.

Compare the challenge of orchestrating a cast of thousands in a consent petition with the simplicity of decanting that requires only the action of the trustee.

Comparing Decanting Statutes

A trustee must have the authority to decant. Using the trustee’s absolute power to invade principal as a foundation, the exercise of a trustee’s power to invade is considered to be the equivalent of the exercise of a limited power of appointment, a position supported by the Restatement (Second) of Property and Restatement (Third) of Property: Donative Transfers, a compilation of common law widely used as a reference for fiduciary conduct. Delaware and Nevada use the same rationale. The Delaware statute states that “a trustee who has authority under the terms of a testamentary instrument or irrevocable inter vivos trust, to invade the principal of a trust (the “first trust”) to make distributions to, or for the benefit of, one or more proper objects of the exercise of the power, may instead exercise such power in favor of a trustee of a trust (the “second trust”) under an instrument other than that under which the power to invade is created.”

All states require that the trustee’s authority to invade must be absolute. However, some states like New York consider a trustee’s power to invade that is limited by the ascertainable standard of health, maintenance, support and education makes decanting impossible. Delaware and Nevada require only that the trustee has the power to invade.

Like other states, Delaware and Nevada require the terms of the second trust to be consistent with the terms of the first trust. Delaware states that the second trust must be for the benefit of “only beneficiaries who are proper objects of the exercise of the power.” “Proper objects” are defined in the first trust, and may include collateral descendants or other beneficiaries. Charities cannot be added in the second trust unless named in the first trust. Intestate heirs are not automatically “proper objects” unless named in the first trust.

Interests can be modified but not deleted. For example, changing an outright bequest to one in trust to protect a spendthrift beneficiary is considered to be within the normal exercise of the trustee's power to invade principal. Decanting cannot reduce the income interest of any trust for which the marital deduction, federal or state, was applied.

For obvious reasons decanting cannot occur over property over which a beneficiary enjoys a partial "presently exercisable power of withdrawal."

Trustees can be individual or corporate. Nevada states that the individual trustee may not make discretionary distributions for himself unless the power is exercised with the consent of an adverse party. Distributions from the first trust to the individual trustee must be in accordance with the ascertainable standard, but no limitation is placed on discretionary distributions by the trustee of the second trust.

Nevada specifically states that a "trustee exercising any power granted pursuant to this section may designate himself or herself or any other person permitted to act as the trustee of the second trust." Delaware is silent on the issue of individual trustees.

Experts recommend that the second trust contain language specifically authorizing decanting should the situation present itself again.

Mechanics of Decanting

The mechanics of decanting are straightforward. Delaware and Nevada require the decanting instrument to be in writing, then signed and acknowledged by the trustee, with a copy of the second trust attached. The document should be placed with the records of the trust. Note that the decanting is not subject to court approval, nor are the beneficiaries notified and/or their consent obtained.

Some commentators believe that a beneficiary's consent to the decanting may have taxable repercussions, while others believe that if a beneficiary permits his or her beneficial interest to pass to another in the decanting process, he or she has made a gift. Concern about gift taxes can be lessened by having an independent trustee do the decanting. Individual beneficiary/trustees decant at their peril. The settlor of the first trust, if living, should not be involved in the decanting process. His permission, consent or any other form of acquiescence could have serious repercussions on his estate plan.

The governing instrument of the second trust takes many forms. It can be a continuation of the first trust, a revision of only a few sections, or a completely new governing instrument. In any event the trustee is the erstwhile "settlor" of the second trust. Delaware does not require the trustee of the first and second trusts to be the same.

Tax Implications of Decanting

The negative effect of decanting is of particular concern when there is generation-skipping transfer tax (GST) planning. Such planning may involve "grandfathered" GST trusts, those trusts that were irrevocable as of September 25, 1985, as well as GST exempt and non-exempt GST trusts created later. The challenge is to avoid triggering a taxable addition that compromises the trust's protected GST status.

Fortunately, the IRS addressed these issues by stating that as long as decanting did not shift beneficial interests from beneficiaries of the first trust to younger-generation beneficiaries in the second trust, and that the time for vesting of beneficial interests was not extended in the second trust, decanting was permitted.

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Additionally, the Delaware statute requires that a beneficiary's remainder interest must vest "no later than the date upon which such interests would have vested ... under the terms of the governing instrument for the first trust." Nevada is silent on the issue.

No federal estate tax consequences should occur because decanting is considered to be the exercise of a limited power of appointment and as such, not a taxable power. As long as the decanting trustee is not a beneficiary, there should be no adverse gift tax concerns.

Decanting from one domestic trust to another should not result in the recognition of income. The second trust could be considered a continuation of the first trust, with no income tax consequences.

Conclusion

In today's trust environment, flexibility and responsiveness are highly valued, yet unavailable in irrevocable trusts because they were written at a time when these qualities were not considered. The beneficiaries of all trusts die, become incapacitated, or manage money poorly, making the terms of the original governing instrument unsuitable. Additionally, beneficiaries now demand more from their trust relationships. They want to manage investments themselves or hire their own investment managers. They want to change the situs of the trust to a more beneficiary-friendly state. Or they want to have the ability to change trustees or appoint individuals that represent the family's interest when a corporate trustee is serving.

Decanting is an efficient way to maintain the tax advantages of irrevocable trusts while solving some of the problems described above. As a unilateral action taken by the trustee, decanting is simpler than gaining approval from multiple beneficiaries, each with their own strongly-held opinions, in a consent petition. The important thing to remember is that there are solutions to revise irrevocable trusts, and your legal advisor is the best person to guide you in the process.

If you or your clients would like to learn more about decanting or any other of our personal trust services, we invite you to contact Amy Brown at 302.888.7740 or abrown@christianatrust.com. For information on our corporate trust services, please speak with Lou Geibel at 302.888.7424 or lgeibel@christianatrust.com.

Clients in the western United States are invited to contact Doris Krick in our Nevada office at 702.732.9734 or dkrick@christianatrust.com to hear more about the benefits and services we can provide through Christiana's Nevada-based location.

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