International Law Office

July 19 2012

JENNIE CHERRY, RASHAD WAREH

Planning for non-US trusts using state decanting laws

Kozusko Harris Duncan | Private Client & Offshore Services - USA

Introduction

Significant planning opportunities now exist for both US and non-US trusts using state decanting laws. Several more states have recently introduced or enacted decanting legislation. The US Treasury Department and the Internal Revenue Service (IRS) released Notice 2011-101 on December 20 2011 requesting comments regarding the tax consequences of decanting. State initiatives are responding to the need or perceived need to provide flexibility in trust administration, while the tax authorities are studying the tax implications of trustee distributions of all or a portion of the principal of an irrevocable trust to another irrevocable trust ('decanting') that result in a change in the administrative provisions or beneficial interests of the distributing trust. Advisers to international families should be familiar with

decanting, as it can provide a trustee wrestling with increasing US tax and reporting obligations a method for addressing their impact on a foreign trust's US beneficiaries.

Decanting

'Decanting' typically refers to the process whereby the funds of an irrevocable trust are paid over to another trust. Usually accomplished by an action of the trustee, the new trust will often have different terms that the trustees and the trust beneficiaries find more favourable. Other than through an explicit grant of authority in the trust agreement, trustee authority to decant was originally found in the common law of some states. The common law rationale maintained that if a trustee has the discretionary power to distribute property to or for the benefit of one or more current beneficiaries, then in effect the trustee has a special power of appointment that should enable the trustee to distribute the property to a second trust for the benefit of such beneficiaries.

State decanting statutes

Beginning with New York in 1992, many states adopted a legislative solution. State decanting statutes expressly permit a trustee to exercise its distribution authority to modify the terms and conditions on which trust property is held for trust beneficiaries, including to limit or change trust beneficiaries (but typically not to add new beneficiaries). The result is to change an otherwise irrevocable trust without the judicial process and proof required for traditional options such as equitable deviation, modification or reformation.

Decanting statutes respond to a perceived need to provide flexibility and are now available in more than one-third of the 50 states; yet they were relatively rare only five years ago. Within the past year alone 10 states have enacted, proposed or modified decanting laws.

Notice 2011-101

Decanting a trust fund from one trust to another may have tax implications for both trusts and their beneficiaries. In response to the increasing number of state decanting laws, Notice 2011-101 asked for comments from the public regarding the income, gift, estate and generation-skipping transfer tax issues and consequences arising from transfers by a trustee of

all or a portion of the principal of a distributing trust to a receiving trust that changes beneficial interests. The public was encouraged to suggest a definition for the type of transfer to be addressed in future IRS guidance on decanting. In addition, the notice asked for comments on the tax consequences of such decanting transfers in the context of domestic trusts, the domestication of foreign trusts and transfers to foreign trusts. Written comments were requested by April 25 2012. Comments were submitted by the American Council of Trusts and Estates Practitioners, the New York State Society of Certified Public Accounts and the New York City Bar Association's Joint Subcommittee of the Trusts, Estates and Surrogate's Courts and Estate and Gift Taxation Committees.

Decanting a non-US trust

Decanting can be a useful tool in the situation where an offshore trust has US beneficiaries. Trusts settled years ago for the benefit of family members who had no connection to the United States may now, after a couple of generations of marriage, birth and death, find themselves with a beneficiary class of predominately US beneficiaries. Given the tax consequences of distributions to US beneficiaries or the new rules taxing the use of trust property held in a foreign trust as a deemed distribution, decanting a portion of the trust to a US trust may be advisable.

It is possible that the trust's provisions and governing law may not permit decanting, in which case the trustee might consider first moving the administration of the trust to a state with a decanting statute. In such case it is important to confirm that the decanting statute of the new state will be available to the trustee. Some decanting statutes explicitly address this issue. In some cases, appointing a co-trustee located in a state will be sufficient to obtain access to that state's decanting statute.

Considerations when decanting

The ongoing evolution of state decanting laws provides numerous possible planning options for trustees and advisers to international families. There are significant differences among the state decanting statutes. The following are some of the main considerations when reviewing a state's decanting law.

Beneficiary consent or notice

No state requires beneficiaries to consent to a trust decanting. Some states (eg, Alaska, Arizona, Delaware, New Hampshire and Tennessee) go further by not requiring notice to beneficiaries. Generally, there is a requirement of between 20 and 60 days' notice to the beneficiaries of the first trust. Notice can become quite burdensome – for example, New York has adopted a significantly more expansive notice requirement mandating that a copy of the decanting instrument and the second trust be sent to:

- the creator of the first trust;
- any person with a right to remove the trustee of the first trust; and
- any person interested in the first or second trust.

Need for court approval

Only one state (Ohio) requires court approval before decanting, and even then only in limited circumstances. A state may also require that a copy of the decanting instrument be filed with the court, such as in New York if the trust has ever been subject to a surrogate's court proceeding. Even though not required, under some circumstances a trustee may want court approval before decanting to preclude later disputes with beneficiaries.

Protection from challenge

Courts generally do not substitute their judgment when reviewing a trustee's exercise of discretion, but intervene only when there has been an abuse of that discretion. Decanting is typically considered the exercise of a trustee's discretionary distribution power and thus should be governed by the same standard of review. Some decanting statutes expressly address this. For example, the New York statute provides that a decanting trustee must act in the best interests of one or more proper objects of the exercise of the power and as a prudent person would. Further, the exercise of the decanting power cannot be contrary to the creator's intent.

Permissive decanting

All decanting statutes permit decanting when the trustee has absolute discretion to distribute principal and income. However, not all states permit decanting under more restrictive distribution standards. Certain states permit decanting only if there is authority to make principal distributions, while other states allow it under either principal or income distribution authority or are silent as to whether the distribution authority is for principal

or income. Similarly, certain states expressly provide that distribution authority permits decanting whether or not it is limited by a standard, while other states allow it only under absolute distribution discretion (not limited by a standard), or are silent and simply require discretion to make distributions without referencing the existence of a standard (thus by implication permitting decanting whether or not distribution discretion is subject to a standard).

No need for distribution

Another important issue is whether decanting is possible even if there is no existing need to make a distribution. Some states have addressed the potentially troublesome issue facing trustees seeking to decant with a limited distribution power. For instance, a trustee of a trust who has the discretion to distribute principal under a health, education, maintenance and support standard may be concerned that decanting to a new trust to make an administrative change is inconsistent with that standard. At least three states permit decanting whether or not there is an existing need to distribute principal or income under any standard provided in the first trust.

Power of appointment

It may be important to a trustee that the decanting statute allows the trustee to grant the beneficiary of a decanted trust a power of appointment. The common law principle that decanting is the exercise of a trustee's distribution authority, which itself is equivalent to a special power of appointment over trust property, is generally unlimited, except to the extent that the trust document itself imposes limits. Thus, a trustee making a decanting distribution should be able to grant powers of appointment to one or more beneficiaries of the new trust, but for limitations in the original trust agreement. Some states have included an express power to add a power of appointment in their decanting statutes, although they vary in their extent. For example, the Delaware, Nevada, New Hampshire, North Carolina, Ohio and South Dakota statutes provide that the permissible appointees of the power of appointment need not be permissible beneficiaries of the decanted trust. New York has a more complicated approach, under which the new trust may continue to grant a power of appointment that is identical to that which existed under the first trust; the

new trust may grant a new power of appointment to any beneficiary who, under the original trust, might have received an outright distribution of principal.

Changing beneficiaries

A trustee may want to eliminate a beneficiary for a number of reasons, from changed financial circumstances to mental health issues; alternatively, a trustee may want to accelerate the interest of a beneficiary who currently has a future interest. Missouri and South Dakota offer the greatest flexibility by permitting the trustee not only to decant in favour of one or more of the current beneficiaries, but also to accelerate a beneficiary with a future or contingent interest to be a current beneficiary. Generally, other decanting statutes either explicitly provide that the second trust may be for one or more of the current beneficiaries, or simply state that the second trust may be for beneficiaries or proper objects of the first trust – in either case effectively permitting removal of some of the current beneficiaries, but without addressing the remaining or contingent beneficiaries. Only a minority of the decanting statutes, other than those of Missouri and South Dakota, expressly address the treatment of future or contingent beneficiaries. No state permits the direct addition of a new beneficiary, which is why the authority to include a power of appointment can be an important consideration.

Change of distribution standard

Another factor is whether decanting can change the distribution standard of the trust. Most states are silent as to whether the distribution standard can be changed, so presumably the standard can be changed through decanting. Subject to tax issues, if a state permits the second trust to include a new power of appointment, the power can be used in some cases to change the standard of distribution for some beneficiaries. However, a number of statutes restrict the trustee's power to change the distribution standard, such as those of Alaska, Delaware, New York, North Carolina and Ohio. North Carolina mandates that if the first trust contains an ascertainable standard, then the second trust must have the same standard exercisable in favour of the same current beneficiaries. Alaska, addressing possible negative tax consequences of a broad power to

change the distribution standard, adopts a more stringent approach and mandates that in all circumstances, the second trust must have the same standard for invading principal that is in the first trust.

Extending length of trust

With the exception of Delaware, every decanting statute either expressly permits or is silent as to the trustee's ability to extend the trust term. Delaware, by contrast, provides that if the second trust has an open class of beneficiaries, then its terms must permit distributions only when and to the extent permitted by the first trust. However, careful attention must be paid to the tax consequences – in particular, US generation-skipping transfer tax consequences – of extending the term of the trust.

Extending the perpetuities period

In some cases, the settlor may have created the original trust in a jurisdiction that did not allow perpetual trusts for non-charitable beneficiaries or limited them to 100 years. In Arizona, Nevada, New Hampshire and, in some circumstances, Delaware, the decanted trust, pursuant to general state trust law, may have a new (and potentially unlimited) perpetuities period. In these states, the perpetuities period for a trust created by the exercise of a limited power of appointment runs from the irrevocable exercise, not the creation, of the power of appointment. Other states (eg, Indiana, New York, Ohio, South Dakota and Tennessee), likely concerned about the latent problems of allowing an extension of the perpetuities period, have chosen to restrict their decanting statutes by forbidding the extension of the perpetuities period beyond that of the first trust. Some state decanting statutes are silent as to extension of the period, but effectively prohibit doing so under their general trust law.

Preventing inadvertent tax complications

Non-US trusts that contained no US tax planning provisions when they were created must be aware that tax complications could arise merely from creating a trust in or moving a trust to a jurisdiction with a decanting statute. For example, where a beneficiary is serving as trustee or holds the power to remove and replace the trustee, an unrestricted decanting power may cause the trust to be included in the estate of the beneficiary for US estate tax purposes. Some states, seeking to ameliorate these and other inadvertent tax concerns, have adopted prophylactics to prevent potential tax complications; New York and North Carolina have enacted outright

prohibitions on decanting when the trustee is also a beneficiary, while Florida, Ohio and Tennessee have the same prohibition in their general trust law. Other states have sought the same tax protection while providing significantly more flexibility to the trustee.

Case study

Suppose that the trustee of a non-US trust is holding the trust fund for the benefit of the settlor's descendants. The settlor has two adult children. One has moved to the United States, is married to a US citizen and has adult US citizen children with children of their own. For many years the foreign trust has owned vacation homes used by the settlor's children. The non-US child is also married and has children, all of whom are currently non-US citizens.

The settlor's children have been successful, do not need distributions from the trust and no longer use the vacation property. The US child may nonetheless be saddled with US reporting obligations because he is a beneficiary of the trust, including the new Form 8938 (for further details please see "IRS releases new form to report specified foreign financial assets"). The trustee could exclude the US child from the beneficiary class, but it will be difficult to benefit US grandchildren in a tax-efficient manner.

The trustee could consider moving the entire trust to a state within the United States. This move would trigger no US reporting, but the trust would carry with it possible adverse US tax and interest charges on distributions to US beneficiaries. Instead, by careful inspection of the trust's distributable net income and undistributed net income (calculated using US tax accounting principles) (for details please see "Taxation of offshore trusts and impact of new lower tax rates") and planning distributions to non-US beneficiaries, the trustee may be able to make a tax-favourable decanting of a portion of the trust to a new irrevocable trust settled in a state within the United States. The receiving trust will have to file Form 3520 with the IRS reporting the transfer (which may have tax consequences depending on the advance planning) but otherwise can proceed as a US domestic trust. The trustee of that new trust may then be able to use the state's decanting statute to establish trusts for US grandchildren and more remote descendants.

Potential advantage to foreign trust administered under US state law

A state's trust laws may be attractive even to a trust with no US beneficiaries. A trust could be moved to a state within the United States with favourable decanting laws and still be classified for US income tax purposes as a foreign trust (for details please see "Taxation of offshore trusts and impact of new lower tax rates"). This allows a trustee to take advantage of modern state trust administration laws without subjecting the trust income to US tax. It may mean that an offshore trustee will need to resign in favour of a state trust company, but the family can continue to keep its key advisers in place because, in addition to decanting laws, several states have recently enacted or introduced directed trust laws, which allow for the separation of investment, distribution and administrative responsibilities traditionally associated with the role of trustee. Many states have enacted legislation clarifying that such responsibilities can be bifurcated in the trust context, so that a trustee can rely on the direction of an investment or distribution adviser, with no responsibility to monitor or review those directions. As states continue to stay competitive, the introduction of domestic asset protection trust laws is expected.

Comment

Increasingly, beneficiaries and trustees of long-term trusts need practical solutions to US tax and reporting obligations that apply to discretionary classes that now include US beneficiaries. The US rules are affecting how the non-US trust holds property. Distributions to US beneficiaries are becoming tax prohibitive. And offshore trustees may not be willing to complete and submit US reporting forms. Taking action to decant a trust and change beneficial interests or move some or all of the trust fund to the United States may provide the international family with a new succession plan that better meets the needs of the next generation of beneficiaries.

For further information on this topic please contact Jennie Cherry or Rashad Wareh at Kozusko Harris Duncan by telephone (+1 212 980 0010), fax (+1 212 202 4484) or email (jcherry@kozlaw.com or rwareh@kozlaw.com).