Decanting Trusts: Irrevocable, Not Unchangeable

Melissa J. Willms
Davis & Willms, PLLC
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
(281) 786-4500
melissa@daviswillms.com

CORPUS CHRISTI ESTATE PLANNING COUNCIL
March 26, 2015

MELISSA J. WILLMS

Davis & Willms, PLLC

Board Certified - Estate Planning and Probate Law
Texas Board of Legal Specialization

Master of Laws (LL.M.) in Tax Law

3555 Timmons Lane, Suite 1250
Houston, Texas 77027

Phone (281) 786-4500
Fax (281) 742-2600
melissa@daviswillms.com

EDUCATION:

- LL.M., Tax Law, University of Houston Law Center, 1996
- J.D., Texas Tech University School of Law, 1992
- B.A., Psychology, B.A., Sociology, University of Texas at Austin, 1987

OTHER QUALIFICATIONS:

- Fellow, The American College of Trust and Estate Counsel (ACTEC) (Member, Estate & Gift Tax Committee)
- Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
- Best Lawyers in America, Trusts and Estates
- Admitted to Practice: State Bar of Texas; Federal District Court for the Southern District of Texas; United States Tax Court

PROFESSIONAL ACTIVITIES:

- Real Estate, Probate and Trust Law Section, State Bar of Texas (Council Member, 2014-2018; Member, Decedents' Estates Committee, 2011-present)
- Tax Section, State Bar of Texas (Council Member, 2013-2015; Vice Chair, Estate and Gift Tax Committee, 2011-2014)
- Fellow, Texas Bar Foundation
- Member, State Bar of Texas (Sections of Real Estate, Probate and Trust Law; Tax); Houston Bar Association (Section of Probate, Trusts and Estates); The College of the State Bar of Texas; Houston Estate and Financial Forum

RECENT SPEECHES AND PUBLICATIONS:

- Author/Speaker: *Between Death and Probate: Selected End-of-Life Issues*, Disability and Elder Lawyers Association, 2015; East Texas Estate Planning Council, 2015; The University of Texas School of Law 16th Annual Estate Planning, Guardianship and Elder Law Conference, 2014
- Panelist: *Planning with SCINs and Private Annuities – Seizing Opportunities While Navigating Complications*, 49th Annual Heckerling Institute on Estate Planning, 2015
- Co-Author/Panelist: *Evaluating Portability, Potential Problems and the Post-ATRA Planning Paradigm*, 40th Annual Notre Dame Tax and Estate Planning Institute, 2014
- Co-Author/Panelist: *Directed Trusts and the Slicing and Dicing of the Trustee's Duties*, ACTEC 2014 Fall Meeting
- Panelist: *The Changing Role of the Fiduciary and Who Represents Them*, State Bar of Texas 38th Annual Advanced Estate Planning and Probate Course, 2014
- Co-Author/Panelist: *It Slices, It Dices, It Makes Julienne Fries: Cutting-Edge Trust Tools*, State Bar of Texas 20th Annual Advanced Estate Planning Strategies Course, 2014
- Author/Speaker: *End-of-Life Issues*, State Bar of Texas Advanced Elder Law Course, 2014
- Co-Author/Speaker: *The Brave New World of Estate Planning*, San Antonio Estate Planners Council's Docket Call in Probate Court, 2014
- Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas on proposed regulations regarding reporting of net investment income tax by trustees of charitable remainder trusts, February 20, 2014
- Author: *Decanting Trusts: Irrevocable, Not Unchangeable*, 6 EST. PLAN. & COMMUNITY PROP. L.J. 35, 2013
- Author: *What Happens After Death?*, The Houston Lawyer, Nov./Dec. 2013 issue
- Co-Author/Panelist: *Trust and Estate Planning in a High-Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know*, The University of Texas School of Law 61st Annual Tax Conference – Estate Planning Workshop, 2013; Amarillo Estate Planning Council 23rd Annual Institute on Estate Planning, 2014
- Author/Speaker: *The Net Investment Income Tax: A Trust and Estate Perspective*, Wednesday Tax Forum, 2013
- Author/Panelist: *Affordable Care Act: A Trust and Estate Perspective*, State Bar of Texas 31st Annual Advanced Tax Law Course, 2013
- Author/Speaker: *Between Death and Probate: Practical Items of Esoterica*, State Bar of Texas 37th Annual Advanced Estate Planning and Probate Course, 2013
- Co-Author/Speaker: *Planning for No Probate: Special Issues with Revocable Trusts and Nonprobate Assets*, Hidalgo County Bar Association, 2013 Probate, Trust & Guardianship Law Course, 2013
- Testimony at public hearing before the United States Department of Treasury and Internal Revenue Service on proposed Section 1411 regulations concerning net investment income tax, Washington, D.C., April 2, 2013
- Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas on proposed regulations regarding net investment income tax under Section 1411 of the Internal Revenue Code, March 4, 2013
- Author/Speaker: *Living with the "New" Estate Tax*, Houston Bar Association, Probate, Trusts and Estates Section, 2013

TABLE OF CONTENTS

DECANTING TRUSTS: IRREVOCABLE, NOT UNCHANGEABLE[1]

I. INTRODUCTION

The term "decanting" sounds mysterious and can evoke fear in some estate planners. In reality, decanting is simply a form of trust modification initiated by a trustee. In the strictest sense, a trustee accomplishes the modification by moving assets from one trust to a new trust, with different terms. Although the future of trust beneficiaries may be unknown, especially to beneficiaries, estate planning attorneys draft trusts designed to last for generations. Decanting comes from this standpoint: a desire for changes in an otherwise irrevocable trust. This article will attempt to demystify the issues by looking at decanting and trust modifications from statutory, common law, and trust agreement standpoints, including issues that arise with regard to income, gift, estate and generation-skipping transfer ("GST") taxes.

II. WHAT IS DECANTING?

Although not defined in the Internal Revenue Code ("Code"), the Treasury Regulations, or any state statute, decanting may be described as the exercise by a trustee of the trustee's discretionary authority to distribute trust property to or for the benefit of trust beneficiaries by distributing assets from one trust to another. Although not referred to as decanting, the concept can be found in the Restatement (Second) of Property: Donative Transfers (Second Restatement) and the Restatement (Third) of Property: Wills and Other Donative Transfers (Third Restatement).[2] Since the Internal Revenue Service (IRS) issued Notice 2011-101 in December 2011 seeking comments regarding the various tax issues associated with decanting, we may see the IRS issue a formal definition in the future.[3]

In the Second Restatement, a trustee's power to distribute property is akin to a special power of appointment.[4] According to the Second Restatement, "[a] power of appointment is authority, other than as an incident of the beneficial ownership of property, to designate recipients of beneficial interests in property."[5] Because a trustee who has discretionary authority to distribute trust property to beneficiaries does not have a beneficial interest in the trust property, but can determine those persons who do have a beneficial ownership, the trustee is said to have a special power of appointment over the trust property.[6] The Second Restatement terms the trustee's power as a special power because the trustee has the power to transfer all or part of the title authorized by the trust agreement.[7] The Second Restatement further provides that unless the donor provides otherwise, when the donor gives the powerholder the right to dispose of the property, the powerholder has the same rights that the powerholder would have if he or she owned the property and was giving it to the object of the power.[8] It follows that, if a trustee has the power and discretion to transfer *full* legal title to a beneficiary, then the trustee should be able to transfer *less than* full legal title by transferring the property *in trust for the beneficiary*, since the beneficial interests are still being transferred to a proper object of the power, i.e., the beneficiary.[9] The Second Restatement does not explicitly address whether this power is held in a fiduciary or nonfiduciary capacity. Presumably, however, because a trustee is exercising this power, the trustee is doing so in a fiduciary capacity.

The Third Restatement makes an important clarification with regard to decanting, although the term decanting is still not used. In the Third Restatement, a distinction is made between powers of appointment and fiduciary distributive powers.[10] Specifically, powers of appointment may be exercised in a nonfiduciary capacity; may be exercised arbitrarily; are personal to the powerholder; and lapse upon the powerholder's death, or other specified expiration, if not exercised.[11] In contrast, fiduciary distributive powers are subject to the same general rules regarding powers of appointment, but these powers must be exercised in a fiduciary capacity, they succeed to any successor trustee, and they survive the death of a trustee.[12] Now, instead of decanting being simply likened to a power of appointment, decanting is likened to a power of appointment, subject to fiduciary standards. It may seem obvious that, if a trustee is going to decant assets from one trust to a

1. A previous version of this article was published in the Estate Planning & Community Property Law Journal at 6 EST. PLAN. & COMMUNITY PROP. L.J. 35 (2013).
2. *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS §§ 11.1–12.3 (1986); RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.23 (2011).
3. IRS Notice 2011-101.
4. RESTATEMENT (SECOND) OF PROP: DONATIVE TRANSFERS § 11.1 cmt. d.
5. *Id.* § 11.1.
6. *See id.* § 11.1 cmt. a, d.
7. *See id.*
8. *See id.* § 19.3.
9. *See id.*
10. RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 cmt. g.
11. *Id.*
12. *Id.*

new trust, the trustee must act as a fiduciary. Even though seemingly obvious, when deciding whether to decant, it is critically important that the trustee examine all applicable fiduciary duties.

In addition, the Third Restatement specifies that, unless the creator of a special power of appointment expressly provides otherwise, powerholders may exercise their power by appointing the property *in trust*, in favor of permissible appointees.[13] Since fiduciary distributive powers are subject to the same general rules as powers of appointment, the ability to appoint in trust would also apply in a decanting situation.[14]

Although the term decanting is new, decanting itself is not a new concept. The most cited case that examines decanting a trust is *Phipps v. Palm Beach Trust Company*.[15] In *Phipps*, a trust created in 1932 gave the individual trustee the discretion to distribute "all or any part of the . . . trust estate, both principal and income," to any one or more of the grantor's descendants.[16] The individual trustee gave written instructions to the corporate trustee to transfer all of the trust property to a new trust for the benefit of the grantor's descendants; the difference between the two trusts was that the new trust gave one of the descendants a testamentary power to appoint income to that descendant's spouse. The corporate trustee filed suit seeking court approval of the transaction. In reviewing the trust agreement, as well as the limited class of persons to whom the trustee could distribute the trust property, the court determined that the individual trustee had a special power of appointment. On appeal, the Florida Supreme Court cited the general rule "that the power vested in a trustee to create an estate in fee includes the power to create or appoint any estate [in] less than a fee[,] unless the [grantor] clearly indicates a contrary intent."[17] Considering the broad discretion given to the individual trustee, the high court approved the transfer of the property from one trust to another—an act that is now known as decanting.[18] Recently, in July 2013, the Massachusetts Supreme Court approved a common law trust decanting by a disinterested trustee who had unlimited discretion to make outright distributions.[19] Like in *Phipps*, the court in *Morse v. Kraft* looked to the language of the trust agreement to approve the decanting.[20] In a very fact-based opinion, which contained no objections by any of the parties but included an affidavit filed by the grantor verifying that the proposal was within his intent, the court ruled that the trustee had authority to decant without court approval or beneficiary consent.[21] Regardless of its limited facts, *Morse* illustrates that, even in the absence of a state statute, decanting is possible.

III. REASONS TO DECANT

Times change, needs change, and laws change. For these and for other reasons, a trustee may find the need to decant. Examples of reasons to decant, which may also apply in the trust modification or reformation context, are as follows:

- Correct a drafting mistake;
- Clarify ambiguities in the trust agreement;
- Correct trust provisions, due to mistake of law or fact, to conform to the grantor's intent;
- Update trust provisions to include changes in the law, including new trustee powers;
- Change situs of trust administration for administrative provisions or tax savings;
- Combine trusts for efficiency;
- Allow for appointment or removal of a trustee without court approval;
- Allow for appointment of special trustee for limited time or purpose;
- Change trustee powers, such as investment options;
- Transfer assets to a special needs trust;
- Adapt to changed circumstances of beneficiary, such as substance abuse and creditor or marital issues, including modifying distribution provisions to delay distribution of trust assets;
- Add a spendthrift provision;
- Divide pot trust into separate share trusts; and
- Partition of trust for marital deduction or generation-skipping transfer tax planning.[22]

13. RESTATEMENT (THIRD) OF PROP: WILLS & OTHER DONATIVE TRANSFERS § 19.14.
14. *See id.* §§ 17.1 cmt. g, 19.14.
15. 196 So. 299 (Fla. 1940).
16. *Id.* at 300.
17. *Id.* at 301.
18. *See also In re Estate of Spencer*, 232 N.W.2d 491, 499 (Iowa 1975) (authorizing a beneficiary-trustee's exercise of a special power of appointment in favor of a new trust); *Wiedenmayer v. Johnson*, 254 A.2d 534, 536 (N.J. Super. Ct. App. Div.) (holding that the trustee's discretionary power to distribute trust property to the beneficiary, which included the power to distribute to trust for the beneficiary, was in the best interest of the beneficiary and was not an abuse of discretion), *aff'd sub nom. Wiedenmayer v. Villanueva*, 259 A.2d 465 (N.J. 1969).
19. *See Morse v. Kraft*, 992 N.E.2d 1021, 1025–27 (Mass. 2013).
20. *Id.*; *see also Phipps*, 196 So. at 300–01 (explaining that the court looked to the language of the trust agreement to approve the decanting).
21. *Morse*, 992 N.E.2d at 1025–27.
22. *See also* Toby Eisenberg, *Uncontested Trust Modifications: Tips and Techniques*, DALL. B. ASS'N, PROBATE, TRUST AND ESTATE LAW SECTION 1 (Apr. 23, 2013),

When considering reasons to decant, an ongoing Connecticut case that applied Massachusetts law illustrates the trustee's need to carefully consider the reasons for decanting and the facts at hand. In *Ferri v. Powell-Ferri,*[23] wife filed for divorce against her husband who was the beneficiary of a trust in which he had a vested right of withdrawal of 75% of the trust principal. His right increased to 100% based on his age. After the divorce petition was filed, the co-trustees of the trust, who were the beneficiary's brother and business associate, decanted the trust property to a new, fully spendthrift lifetime trust for husband's benefit and then sought court approval for their actions. The court declined to find that the co-trustees' actions rose to the level of a fraudulent conveyance and declined to recognize a new tort of "intentional interference with an equitable interest." However, noting the significance of the co-trustees' attempted decanting after the beneficiary's right to withdraw trust property had ripened, the court found that language in the trust agreement giving the trustee power to "segregate irrevocably. . .income and principal. . .as my Trustee deems desirable for [beneficiary]'s benefit" was not broad enough to give the co-trustee's absolute power over the trust property and held the decanting was invalid.[24] In other words, although the court declined to find that the co-trustees had breached their fiduciary duties, the court found that the co-trustees went too far.

IV. DECANTING VS. TRUST MODIFICATION

A. Fiduciary Duties of Trustees. When taking any action, including decanting or trust modification, trustees must consider whether the action falls within the various fiduciary duties they owe the beneficiaries.[25] Trustees cannot act arbitrarily.[26] Two principles underlie much of the Anglo-American law of fiduciary duties: the duty of loyalty and the duty of prudence.[27] As applied to trustees, specific duties vary from state to state; however, a number of general principles remain consistent.[28] A discussion of a few of these duties, specific to Texas law, follows.

1. Duty of Loyalty. Without question, the duty of loyalty is one of the most basic fiduciary duties of a trustee, and it underlies virtually every action of a trustee. The duty of loyalty requires trustees to act in the best interests of the beneficiaries above their own interests, while remaining fair and impartial to all of the beneficiaries.[29] A trustee's duty to avoid self-dealing is a subpart of the duty of loyalty.[30]

2. Fiduciary Duty to Be Generally Prudent. Trustees have a duty to act reasonably and competently in all matters of trust administration, not just in investment matters.[31] A trustee must administer the trust in good faith and in accordance with the terms of the trust and the Texas Trust Code, as well as perform all duties imposed by common law.[32] Although prior Texas law required a trustee to act as an ordinary prudent person when investing and managing trust property, this requirement was deleted when Texas adopted the Uniform Prudent Investor Act.[33] Presumably, however, based on common law, the duty still applies.

3. Duty to Control and Protect Trust Property. Common law imposes numerous duties on trustees with regard to controlling and protecting trust property, such as insuring the trust property and enforcing claims against third parties. A trustee has a duty of loyalty requiring the trustee to "manage the trust assets solely in the interest of the beneficiaries."[34] Accordingly, the Texas Trust Code has limitations on acts of self-dealing.[35] "If a trust has two or more beneficiaries, the trustee [must] act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries."[36] After becoming a trustee or receiving

---

https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&ved=0CDMQFjAB&url=http%3A%2F%2Fwww.dallasbar.org%2Fsystem%2Ffiles%2Funcontested_trust_modifications.pdf%3Fdownload%3D1&ei=lEJkUuKVM8er2gWWo4DoDw&usg=AFQjCNEQBLOVQ0s4ZTUzGmMxu3AwLiGT6Q&sig2=_2erXVL1FrVigXj5DCfT9w&bvm=bv.54934254,d.b2I; WIS. STAT. § 701.0418(4)(a) which provides a non-exclusive list of 19 reasons for which decanting may be permissible .

23. 2013 Conn. Super. LEXIS 1938 (2013). Note that as mentioned above, Massachusetts does not have statutory decanting.

24. The court stated that to allow the decanting would "improperly eviscerate" the trust provisions giving the beneficiary the right of withdrawal, and if the grantor had wanted to make the trustee's power absolute, he could have done so in the trust agreement.

25. *See* RESTATEMENT (THIRD) OF TRUSTS §§ 76–84 (2007).

26. *See id.* § 76.

27. *See id.* §§ 77, 78.

28. *See id.* §§ 76-84.

29. *See Slay v. Burnett Trust*,187 S.W.2d 377 (Tex. 1945); *see also* TEX. PROP. CODE ANN. §§ 113.051, 132.053, 117.007.

30. *See* TEX. PROP. CODE ANN. § 117.007; RESTATEMENT (THIRD) OF TRUSTS § 78(b).

31. *See Interfirst Bank Dallas, N.A. v. Risser*, 739 S.W.2d 882, 888 (Tex. App. BTexarkana 1987, no writ); *Tucker v. Dougherty Roofing Co.*, 137 S.W.2d 884 (Tex. Civ. App.—Dallas 1940, *writ dism'd judgmt cor.*).

32. TEX. PROP. CODE ANN. § 113.051.

33. *See* Act of June 16, 1991, 72d Leg., R.S., ch. 876, § 1, sec. 113.056(a), 1991 Tex. Gen. Laws 2987 (amended 2003) (current version at TEX. PROP. CODE ANN. § 117.001–.012).

34. TEX. PROP. CODE ANN. § 117.007.

35. *See, e.g., id.* § 113.052–.055.

36. *Id.* § 117.008.

trust assets, the trustee has a reasonable time to review the assets and decide how to manage them, in order to bring the trust into compliance with the trust's purposes, the trust's terms, and the Texas Trust Code.[37] When a successor trustee takes over, the successor must "make a reasonable effort to compel the predecessor trustee to deliver the trust property."[38]

4. Duty to Inform and Report. A fundamental duty of a trustee is to keep the beneficiaries reasonably informed of the administration of the trust.[39] Incident to the trustee's general duty to account and the trustee's particular duty to provide information, is the trustee's duty to keep written accounts that show the nature, amount, and administration of the trust property, as well as all of the acts performed by the trustee.[40] Disclosure to beneficiaries need not take the form of audited financial statements; when beneficiaries have long accepted informal financial statements and tax returns in lieu of more formal accountings, they may be estopped from insisting upon more formal disclosures.[41] Keep in mind that a beneficiary has the right to demand an accounting.[42] In the case of decanting, a trustee's duty to inform calls into question whether a trustee needs to inform the beneficiaries prior to, or concurrent with, the decanting.[43]

5. Implications of Fiduciary Duties. The purpose of the decanting is an important factor in determining the interaction with and impact on a trustee's fiduciary duties. For example, decanting to make purely administrative changes should not raise problems with a trustee's duty of loyalty. However, if a trustee's actions will cause a preference for one beneficiary over another or if the actions will shift beneficial interests, duty of loyalty issues may arise.[44] If the trust agreement includes provisions permitting decanting, such language may be enough authority for the trustee to act, but it does not mean the action would be proper or would fall within the trustee's fiduciary duties.[45] Trustees could obtain more protection if the grantor includes language in the trust agreement that exonerates the trustees for exercising their discretionary authority to decant.[46]

When the trust agreement is silent as to a specific type of decanting, trustees may believe that it would be best to obtain the beneficiaries' consent or a release from the beneficiaries. Alternatively, trustees sometimes believe that it would be best to obtain a court order approving the decanting or to include an indemnification agreement in the new trust. As discussed below, however, there are potential tax consequences to these actions. Commentators have suggested that the better approach is to use a receipt and refunding agreement.[47]

Absent any tax concerns or other issues, if the trustee has an overriding concern about liability, the best course may be to seek a judicial modification of the agreement in order to provide the trustee with the "cover" of a court order. If the grantor wants to maintain maximum flexibility in the trust, while minimizing the trustee's concerns with liability, the grantor may consider giving a third party, in a nonfiduciary capacity, the power to appoint trust property to another trust.

B. Modifying and Terminating Trusts. What if our estate planning was not so far-sighted as to put all of the flexibility we want into the estate plan? Is it too late to modify or terminate the so-called irrevocable trusts that we have created?[48] If these trusts can be changed, what are the tax and other consequences of doing so?

1. Modifications Under Common Law. Common law has long contained a well established, if very limited, notion of trust modification, known as

37. *Id.* § 117.006.
38. *Id.* § 114.002.
39. *See Huie v. DeShazo*, 922 S.W.2d 920, 923 (Tex. 1996); *Montgomery v. Kennedy*, 669 S.W.2d 309, 313 (Tex. 1984).
40. *See* TEX. PROP. CODE ANN. § 113.151(a); *Corpus Christi Bank & Trust v. Roberts*, 587 S.W.2d 173, 182 (Tex. Civ. App.—Corpus Christi 1979) (citing RESTATEMENT (FIRST) OF TRUSTS § 72 (1935)), *aff'd*, 597 S.W.2d 752 (Tex. 1980); *Shannon v. Frost Nat'l Bank*, 533 S.W.2d 389, 393 (Tex. Civ. App.—San Antonio 1975, *writ ref'd n.r.e.*).
41. *See Beaty v. Bales*, 677 S.W.2d 750, 755–56 (Tex. App.—San Antonio 1984, *writ ref'd n.r.e.*).
42. TEX. PROP. CODE ANN. § 113.151.
43. *See* RESTATEMENT (THIRD) OF TRUSTS § 82 (2007).
44. *See id.* § 79.
45. *See* RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 cmt. g (2011).
46. *See, e.g.*, William R. Culp, Jr. & Briani Bennett Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 45 REAL PROP. TR. & EST. L.J. 1, 48–49 (2010).
47. *See id.* at 45.
48. *See generally* Eric G. Reis, *Irrevocable or Not? Modifications to Trusts*, ST. B. TEX., 33RD ANNUAL ADVANCED ESTATE PLANNING AND PROBATE COURSE (June 10–12, 2009), http://www.tklaw.com/files/Publication/e5d85861-ebbd-4b45a0a8-d116d8a17409/Presentation/PublicationAttachment/2b16c64f-a6d0-4c5b-9f67-0d7c8a7aa21e/Irrevocable%20or%20Note%20SBOT%202009.pdf (discussing the procedures and issues involved in terminating and modifying trusts); Glenn M. Karisch, *Modifying and Terminating Irrevocable Trusts*, ST. B. TEX., 23RD ANNUAL ADVANCED ESTATE PLANNING AND PROBATE COURSE (June 4, 1999), http://texasprobate.net/articles/modifyingorterminatingtrusts.pdf (discussing terminating and modifying irrevocable trusts).

the "doctrine of deviation."[49] In fact, even prior to the adoption of the Texas Trust Code in 1983, the legislature recognized this rule. Section 46(C) of the Texas Trust Act provided:

> Nothing contained in this Section of this Act shall be construed as restricting the power of a court of competent jurisdiction to permit and authorize the trustee to deviate and vary from the terms of any will, agreement, or other trust instrument relating to the acquisition, investment, reinvestment, exchange, retention, sale, supervision or management of trust property.[50]

The doctrine of deviation was summarized by the Dallas Court of Civil Appeals:

> A court of equity is possessed of authority to apply the rule or doctrine of deviation implicit in the law of trusts. Thus[,] a court of equity will order a deviation from the terms of the trust *if it appears to the court that compliance with the terms of the trust is impossible, illegal, impractical or inexpedient, or that owing to circumstances not known to the settlor and not anticipated by him, compliance would defeat or substantially impair the accomplishment of the purpose of the trust*. In ordering a deviation[,] a court of equity is merely exercising its general power over the administration of trust; it is an essential element of equity jurisdiction.[51]

Courts have frequently exercised the power to deviate from the administrative provisions of a trust instrument to give full effect to its dispositive or beneficial provisions.[52] Scholars have maintained, however, that courts should proceed more carefully when deviating from the dispositive or beneficial scheme.[53] This limitation does not preclude a court from altering the grantor's dispositive scheme. Rather, it means the court must exercise more care. Examples where the grantor's dispositive scheme may be altered are cases where a statute, such as Section 112.054 of the Texas Trust Code, supports the court's action or cases where the parties to litigation alter the trust's terms by entering into a compromise agreement that the court finds to be fair and reasonable. It appears that, notwithstanding the common law authority to modify and terminate trusts, Texas courts have traditionally shown reluctance to apply these equitable principles. For example, in *Frost National Bank v. Newton*, the Texas Supreme Court held that a trust could not be terminated on the basis that its principal purposes had been satisfied because the court could not substitute its judgment for that of the grantor in determining which purposes the grantor considered "principal" and which were merely "incidental."[54]

2. Modifications Under the Texas Trust Code. Perhaps in response to the general unwillingness of courts to act, in 1984, the Texas legislature enacted a statutory provision adopting the doctrine of deviation, as stated in Section 167 of the Second Restatement of Trusts and in *Amalgamated Transit Union v. Dallas Public Transit Board*.[55] In 2005, the Real Estate, Probate and Trust Law Section of the State Bar of Texas sponsored legislation that broadened Section 112.054 of the Texas Trust Code. The legislation added many of the trust modification and termination provisions outlined in the Uniform Trust Code, thereby expanding the bases for judicial modification or termination of irrevocable trusts and making it easier to meet the statutory standard.

a. Statutory Language. The current version of the statute provides:

> § 112.054. JUDICIAL MODIFICATION OR TERMINATION OF TRUSTS.
>
> (a) On the petition of a trustee or a beneficiary, a court may order that the trustee be changed, that the terms of the trust be modified, that the trustee be directed or permitted to do acts that are not authorized or that are forbidden by the terms of the trust, that the trustee be prohibited from performing acts required by the terms of the trust, or that the trust be terminated in whole or in part, if:

49. *See generally* RESTATEMENT (SECOND) OF TRUSTS § 167 (1959) (stating that a trustee may deviate from a trust).

50. Act of April 19, 1943, 48th Leg., R.S., ch. 148, § 46, 1943 Tex. Gen. Laws 232, 247, *repealed by* Act of Jan. 1, 1984, 68th Leg., R.S., ch. 576, 1983 Tex. Gen. Laws 3475.

51. *Amalgamated Transit Union v. Dall. Pub. Transit Bd.*, 430 S.W.2d 107, 117 (Tex. Civ. App.—Dallas 1968, writ ref'd n.r.e.) (emphasis added) (citation omitted) (citing RESTATEMENT (SECOND) OF TRUSTS § 167).

52. *See* RESTATEMENT (SECOND) OF TRUSTS § 167.

53. *See* GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 561 (rev. 2d ed. 1993) [hereinafter BOGERT].

54. *Frost Nat'l Bank v. Newton*, 554 S.W.2d 149, 154 (Tex. 1977).

55. *See* TEX. PROP. CODE ANN. § 112.054; *Amalgamated Transit Union v. Dall. Pub. Transit Bd.*, 430 S.W.2d 107, 117 (Tex. Civ. App.—Dallas 1968, *writ ref'd n.r.e.*); RESTATEMENT (SECOND) OF TRUSTS § 167 (1959).

> (1) the purposes of the trust have been fulfilled or have become illegal or impossible to fulfill;
>
> (2) because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust;
>
> (3) modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration;
>
> (4) the order is necessary or appropriate to achieve the settlor's tax objectives and is not contrary to the settlor's intentions; or
>
> (5) subject to Subsection (d):
>
> (A) continuance of the trust is not necessary to achieve any material purpose of the trust; or
>
> (B) the order is not inconsistent with a material purpose of the trust.
>
> (b) The court shall exercise its discretion to order a modification or termination under Subsection (a) in the manner that conforms as nearly as possible to the probable intention of the settlor. The court shall consider spendthrift provisions as a factor in making its decision whether to modify or terminate, but the court is not precluded from exercising its discretion to modify or terminate solely because the trust is a spendthrift trust.
>
> (c) The court may direct that an order described by Subsection (a)(4) has retroactive effect.
>
> (d) The court may not take the action permitted by Subsection (a)(5) unless all beneficiaries of the trust have consented to the order or are deemed to have consented to the order. A minor, incapacitated, unborn, or unascertained beneficiary is deemed to have consented if a person representing the beneficiary's interest under Section 115.013(c) has consented or if a guardian ad litem appointed to represent the beneficiary's interest under Section 115.014 consents on the beneficiary's behalf.[56]

b. Application of the Statute. While the statute appears to provide a comprehensive method to modify trusts, its application is, in many ways, quite limited.[57]

(1) Trustee or Beneficiary May Bring Suit. Section 112.054(a) provides that a trustee or a beneficiary may petition the court to modify or terminate a trust.[58] A beneficiary is "a person for whose benefit property is held in trust, regardless of the nature of the interest."[59] Therefore, it appears that "any beneficiary—income, remainder, contingent remainder—has standing to bring a modification or termination suit."[60] Note that the statute does not authorize a grantor to petition the court. Although a grantor may be an 'interested person' for purposes of Section 115.011 which is the 'parties' section, Section 112.054 does not empower actions by interested parties.

(2) Authority of Court. Section 112.054 is entitled "Judicial Modification or Termination of Trusts."[61] Nevertheless, it authorizes the court to do more than modify administrative terms or terminate a trust. In particular, the statute authorizes the court to: (1) change the trustee; (2) modify the terms of the trust; (3) direct or permit the trustee "to do acts that are not authorized or that are forbidden by the terms of the trust"; (4) prohibit the trustee "from performing acts required by the terms of the trust"; or (5) terminate the trust in whole or in part.[62] While this list is fairly broad, it does not authorize a court to ignore a trust in its entirety or rewrite the trust from scratch. It is likely that decanting under common law provides much broader authority than statutory judicial modification to change the terms of the trust. Depending on a trust's terms, statutory decanting certainly provides broader authority to change the terms of the trust than judicial modification.

(3) Findings Required. Prior to the 2005 legislative changes, a court could act under Section 112.054 only if it found the following:

> "(1) [T]he purposes of the trust have been fulfilled or have become illegal or impossible to fulfill; or (2) because of circumstances not known to or anticipated by the [grantor], compliance with the terms of the trust would defeat or substantially impair the

56. TEX. PROP. CODE ANN. § 112.054.

57. *See* Karisch, *supra* note 48, at 10 (noting that one of the limitations to the statute's application is the definition and interpretation of the term "beneficiary").

58. TEX. PROP. CODE ANN. § 112.054(a).

59. *Id.* § 111.004(2)

60. Karisch, *supra* note 48, at 3.

61. TEX. PROP. CODE ANN. § 112.054.

62. *Id*. § 112.054(a).

> accomplishment of the purposes of the trust."[63]

The new statute kept the first ground, but it substantially reduced the burden for establishing the second ground by changing "defeat or substantially impair" to "further the purpose of the trust."[64] In addition, the new statute added three new grounds for modifying or terminating a trust, allowing changes: (i) to "nondispositive terms of the trust [if] necessary or appropriate to prevent waste or avoid impairment of the trust's administration"; (ii) to "achieve the [grantor's] tax objectives [if] not contrary to the [grantor's] intentions"; and (iii) to terminate a trust that "is not necessary to achieve any material purpose of the trust" or if termination "is not inconsistent with a material purpose of the trust."[65]

(4) Spendthrift Clauses Not an Impediment. Texas Trust Code Section 112.054(b) provides that a court must "consider spendthrift provisions as a factor in making its decision whether to modify or terminate [a trust], but the court is not precluded from exercising its discretion to modify or terminate solely because the trust is a spendthrift trust."[66] This provision is important because most irrevocable trusts include spendthrift provisions. As noted by Karisch, "[a]bsent this statutory language, it would not be unexpected for a court to conclude that the grantor did not want the beneficiaries to have the power to deal with and/or receive the trust property prior to the time for distribution under the trust instrument."[67] According to Section 112.054(b), a spendthrift provision is one factor to consider, but is not an automatic bar to granting a modification or termination.

(5) Virtual Representation, Charitable Beneficiaries, and Related Issues. It is often difficult or impossible to get all of the beneficiaries before the court, especially since minor, incapacitated, unborn, or unascertained beneficiaries do not have capacity to participate in a judicial modification or termination proceeding. Without some way to bind these beneficiaries, trustees and other interested persons will be hesitant to proceed. One alternative is to appoint a guardian of the estate or a guardian ad litem for such persons.[68] Fortunately, in deciding how to act, Section 115.014(c) of the Texas Trust Code allows "[a] guardian ad litem [to] consider general benefit accruing to the living members of a person's family."[69] By giving a guardian ad litem the ability to look at the benefits to the entire family for the change rather than just to the minor or unascertained beneficiaries, guardian ad litem approval is easier to obtain. As another alternative, under Section 115.013(c) of the Texas Trust Code, "if there is no conflict of interest and [if] no guardian of the estate or guardian ad litem has been appointed, a parent may represent his minor child as guardian ad litem or as next friend."[70] Also, "an unborn or unascertained person who is not otherwise represented is bound by an order to the extent his interest is adequately represented by another party having a substantially identical interest in the proceeding."[71]

While this statutory statement of "virtual representation" is limited to parents acting for their minor children and other beneficiaries acting for unborn or unascertained persons, cases do not appear to limit virtual representation to minors and unborns.[72] In short, in most cases where trust modification or termination is sought, Section 115.013(c), together with the necessary parties statute, Section 115.011, provides a safe harbor.

> [I]f all of the necessary parties described in Section 115.011 can be served or otherwise brought into the suit, if all minors can be represented by their parents without a conflict of interest, and if the interests of all unborn or unascertained persons are adequately represented by another party having a substantially identical interest, then a guardian ad litem generally can be avoided and the parties can have a moderate level of comfort that the modification or termination order will be binding on all beneficiaries. If some or all of these requirements cannot be met, then one or more ad litems probably are necessary under Section 115.014.[73]

In actions involving a trust with charitable beneficiaries, any modification or termination may affect the interest of the charity as a beneficiary, and

63. Act of May 24, 1985, 69th Leg., R.S., ch. 149, § 1, sec. 112.054, 1985 Tex. Gen. Laws 676 (amended 2005) (current version at TEX. PROP. CODE ANN. § 112.054(a)).
64. *Compare id.*, *with* TEX. PROP. CODE ANN. § 112.054(a)(2).
65. TEX. PROP. CODE ANN. § 112.054(a).
66. *Id.* § 112.054(b).
67. *See* Karisch, *supra* note 48, at 6.
68. *See* TEX. PROP. CODE ANN. §§ 112.054(d), 115.013(c)(2)(A), 115.014(a).
69. *Id.* § 115.014(c).
70. *Id.* § 115.013(c)(3).
71. *Id* . § 115.013(c)(4).
72. *See, e.g.*, *Mason v. Mason*, 366 S.W.2d 552, 554 (Tex. 1963) (holding that the doctrine of virtual representation is not limited to beneficiaries representing other beneficiaries where trustee was found to have virtually represented the beneficiaries in a suit challenging the validity of the trust).
73. Karisch, *supra* note 48, at 12.

therefore, the charity must be made a party.[74] In addition, Texas law requires the party initiating any proceeding involving a charitable trust to give notice to the Texas Attorney General.[75] The party must send the attorney general, by registered or certified mail, "a true copy of the petition or other instrument initiating the proceeding involving a charitable trust within 30 days of [the] filing of the petition or other instrument, but no less than 25 days prior to a hearing in the proceeding."[76] If the attorney general is not given notice, any judgment is voidable.[77] Furthermore, at any time, the attorney general may intervene in a proceeding involving a charitable trust, and the attorney general "may join and enter into a compromise, settlement agreement, contract or judgment relating to a proceeding involving a charitable trust."[78]

(6) No Justiciable Controversy Required. "Proceedings under § 112.054 of the Texas [Trust] Code do not require a justiciable controversy."[79] In other words, no actual controversy is required in order to seek a judicial modification or termination of a trust.

3. Trust Divisions, Combinations and "Mergers" Under the Texas Trust Code. If the substance of a trust instrument is acceptable, but the administrative provisions are problematic, an alternative to a modification action under Section 112.054 might be to seek a trust combination, or "merger." Section 112.057 of the Texas Trust Code was amended in 2005 to give trustees broader authority (without judicial intervention) to divide and combine trusts.[80] Prior to this amendment, the Texas Trust Code authorized a trustee to merge trusts only if the trusts had identical terms and only if the trustee determined that the merger would result in significant tax savings.[81] In 2005, the legislature adopted language based on the Uniform Trust Code, which gives trustees significantly broader authority to combine trusts.[82] Although this combination of trusts is often referred to as "merging," the revised statute uses the term "combine"—perhaps to avoid confusion of the common law notion of merging interests, the effect of which is to terminate a trust, and to avoid any suggestion that the trusts may be combined without income tax effects.[83]

a. No Impairment. Section 112.057(c) requires trustees to show that a division or a combination of the two trusts will "not impair the rights of any beneficiary or adversely affect achievement of the purposes of one of the separate trusts."[84] The Trust Code does not define what constitutes impairing the rights of a beneficiary. The drafters of the Uniform Trust Code, which contains similar language, expressed the notion this way:

> Typically the trusts to be combined will have been created by different members of the same family and will vary on only insignificant details, such as the presence of different perpetuities savings periods. The more the dispositive provisions of the trusts to be combined differ from each other the more likely it is that a combination would impair some beneficiary's interest, hence the less likely that the combination can be approved.[85]

b. No Consent Required. If the trustees of two trusts determine that the trusts can be combined, or if a trustee of a trust determines the trust can be divided, they may do so without the consent of the beneficiaries, but the trustees must give the beneficiaries notice of the combination or division not later than thirty days prior to the effective date of the combination or division.[86] Such notice must be given to those beneficiaries who are entitled to receive distributions or who will be entitled to distributions once division or combination is complete, although the beneficiaries may waive such notice.[87]

c. Two-Step Decanting to Divide and Combine. In Private Letter Ruling 200451021, the IRS ruled that, when state law and the trust agreement permitted a division of trusts into separate trusts, followed by the immediate merger of the separate trusts with other existing trusts, no adverse income, gift, or GST tax consequences would occur.[88] The facts of the ruling indicate that the trustee proposed to partition each GST-exempt trust into two trusts, subject to court approval, with each trust holding a different type of

74. TEX. PROP. CODE ANN. §§ 112.054(d), 123.001 *et seq*.
75. *See id.* § 123.003(a).
76. *Id.*
77. *Id.* § 123.004.
78. *Id.* § 123.002.
79. *Gregory v. MBank Corpus Christi, N.A.*, 716 S.W.2d 662, 666 (Tex. App.—Corpus Christi 1986, no writ).
80. *See* TEX. PROP. CODE ANN. § 112.057(c).
81. *See* Act of Sept. 1, 1991, 72d Leg., R.S., ch. 895, § 18, sec. 112.057, 1991 Tex. Gen. Laws 3062, 3069–70 (amended 2005) (current version at TEX. PROP. CODE ANN. § 112.057).
82. *Compare id., with* TEX. PROP. CODE ANN. § 112.057(c) (allowing trustees to combine trusts, unless the terms of the trust expressly prohibit such combination).
83. *See* TEX. PROP. CODE ANN. § 112.034, .057(c); *see also* IRC § 368(a)(1)(A) (describing tax-free mergers of corporations).
84. TEX. PROP. CODE ANN. § 112.057(c).
85. UNIF. TRUST CODE § 417 cmt. (2005).
86. TEX. PROP. CODE ANN. § 112.057(c)(1).
87. *See id.*; *see also id.* § 112.057(e).
88. *See* PLR 200451021 (Dec. 17, 2004).

asset. One of these new trusts would then merge into an existing trust that had the same terms and benefitted the same beneficiaries. The IRS ruled: neither the partition of each trust nor the merger of any of the trusts would cause a GST-tax to be imposed; no gain or loss would be realized and the merged trusts would receive a carryover basis and holding period in the assets that each received. In addition, the IRS ruled that the partition of the trusts was a qualified severance; therefore, for GST-tax purposes, all of the new trusts would retain their zero inclusion ratios.[89]

4. Reformation and Rescission. While reformation and rescission suits are similar to modification and termination suits, the basis for the suits are different.[90]

a. Reformation. Reformation suits are based on mistakes of fact at the inception of the trust, not deviations from the trust terms due to changed circumstances. In other words, a reformation results in the trust terms being reformed to read as they always should have read.

> If, due to a mistake in the drafting of the trust instrument, [the instrument] does not contain the terms of the trust as intended by the [grantor] and trustee, the [grantor] or other interested party may maintain a suit in equity to have the instrument reformed so that it will contain the terms which were actually agreed upon.[91]

Most courts have held that reformation must be based upon a mistake of fact, not a mistake of law; however, courts have usually applied this limitation on reformation to mistakes of fact regarding the general rules of law and not to mistakes regarding particular, private legal rights and interests.[92] In other words, if parties contract under a mutual mistake and misapprehension as to their specific rights, the agreement may be set aside as having proceeded upon a common mistake. In *Furnace v. Furnace*, for example, the parties were mistaken as to what effect a sale would have on their interests in a trust. Even though legal interpretations of instruments were involved, dicta in the opinion indicates that this was a mistake of fact, not of law.[93] Additionally, courts in other jurisdictions have extended the doctrine of reformation to mistakes of law made by the scrivener of the trust agreement, where the grantor relied on the scrivener and could not reasonably be expected to have known the legal implications of the language in the trust agreement.[94]

b. Rescission. If a grantor never intended to create a trust, then rescission is the proper remedy.[95] Rescission is a remedy provided by common law. In *Wils v. Robinson*, the court of appeals found that Section 112.054(a)(2) of the Texas Trust Code was not a basis for terminating a trust that the grantor said he never intended to create. Rather, rescission was the proper remedy, based on mistake, fraud, duress, or undue influence.[96]

5. Modification or Termination by Agreement of Grantor and Beneficiaries. "[I]f a [grantor] of a trust is alive and all of the beneficiaries of an irrevocable spendthrift trust consent (and there being no incapacity to consent by any of the parties), the [grantor] and all of the beneficiaries may consent to a modification or termination of the trust."[97] It appears that Texas case law makes no provision that the trustee consent or even be a party to a nonjudicial agreement to modify or terminate a spendthrift trust. In contrast, Section 112.051(b) of the Texas Trust Code provides that the grantor of a trust "may modify or amend a trust that is revocable, but the [grantor] may not enlarge the duties of the trustee without the trustee's express consent."[98] In that a trustee must accept the job, it certainly makes sense that if the trustee's duties are to be expanded, the trustee must consent. Therefore, if a modification of a spendthrift trust will expand the trustee's duties, prudence dictates obtaining the trustee's consent. Keep in mind that there are two important practical impediments when a grantor and all of the beneficiaries modify or

89. *See id.*

90. *See* TEX. PROP. CODE ANN. § 112.054; *see also* RESTATEMENT (SECOND) OF TRUSTS § 333 cmt. a (1959).

91. BOGERT, *supra* note 53, § 991.

92. *See, e.g.*, *Cmty. Mut. Ins. Co. v. Owen*, 804 S.W.2d 602, 604–05 (Tex. App.—Houston [1st Dist.] 1991, *writ denied*).

93. *See Furnace v. Furnace*, 783 S.W.2d 682, 686 (Tex. App.—Houston [14th Dist.] 1989, *writ dism'd w.o.j.*).

94. *See, e.g.*, *Carlson v. Sweeney*, 895 N.E.2d 1191, 1200 (Ind. 2008); *Loeser v. Talbot*, 589 N.E.2d 301, 305 (Mass. 1992) (holding that the trust could be reformed to effect grantor's clearly stated intent to save GST taxes); *cf. DuPont v. S. Nat'l Bank of Houston.*, 575 F. Supp. 849, 862 (S.D. Tex. 1983), *aff'd in part, vacated in part*, 771 F.2d 874 (5th Cir. 1985) (explaining that the grantor's evidence—that he would not have created the trust but for his alleged mistake as to tax consequences—was insufficient).

95. *See Wils v. Robinson*, 934 S.W.2d 774, 780 (Tex. App.—Houston [14th Dist.] 1996), *vacated pursuant to settlement*, 938 S.W.2d 717 (Tex. 1997).

96. *Id.* at 779.

97. *Musick v. Reynolds*, 798 S.W.2d 626, 629 (Tex. App.—Eastland 1990, *no writ*) (citing *Sayers v. Baker*, 171 S.W.2d 547, 551–52 (Tex. Civ. App.—Eastland 1943, *no writ*)); *see also Becknal v. Atwood*, 518 S.W.2d 593 (Tex. Civ. App. —Amarillo 1975, no writ).

98. TEX. PROP. CODE ANN. § 112.051(b).

terminate the trust by agreement.[99] First, the grantor is often deceased, which makes this method impossible to pursue. Second, oftentimes there are minor or contingent beneficiaries, and although virtual representation is available for judicial modifications and terminations, it is not available for this method.

V. STATUTORY DECANTING

A. "Decanting." In effect, decanting statutes allow a trustee with discretionary distribution authority over a trust to modify the trust's terms and conditions by pouring trust assets into a new trust with, for example, more or less restrictive dispositive provisions, different successor trustees, different governing law provisions, and so on. Decanting is the next step in the evolution of trust law, where it is becoming clearer that, for trusts, "irrevocable" does not mean "unchangeable."

Several states, including Texas, permit a trustee who has discretion to make distributions to or for the benefit of the beneficiary to make a distribution into a new trust for that beneficiary. New York, in 1992, became the first state to enact a decanting statute. In 2005, the Texas legislature adopted a very limited version of this ability to decant from one trust to another.[100] Section 113.021(a) of the Texas Trust Code provides that a trustee who holds property for a beneficiary who "is a minor or a person who in the judgment of the trustee is incapacitated by reason of legal incapacity or physical or mental illness or infirmity" may retain trust property "as a separate [trust] on the beneficiary's behalf."[101] Several states—starting with Delaware, New York, and Alaska, but recently including Tennessee, Florida, South Dakota, Texas, and others—have broadened this authority to enable a trustee to distribute, or decant, assets from an old, "bad" trust into a new, "good" trust. Currently, twenty-two states have adopted decanting statutes: Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Wisconsin, and Wyoming.[102] The following discussion gives a detailed overview of the various state statutes as of March 1, 2015; however, this discussion is not an exhaustive analysis.[103]

1. Decanting by Trustee. Typically, it is the trustee who must have the ability to decant; however, some statutes prohibit or limit a trustee from having the power to decant if the trustee is also a beneficiary.[104]

2. Applying State Law. If a trust is governed by a state that has a decanting statute and if the trust agreement does not prohibit decanting, the state's statute will apply. Most states with a decanting statute will apply the statute to a trust that moves its situs to that state.[105]

Absent a prohibition in the trust agreement, commentators suggest that anyone can decant by invoking the law of a state with favorable decanting rules. A trustee cannot simply choose to apply the law of a state to which the trust has no nexus; however, it may be fairly easy to establish the required nexus.[106] The most common approach is to seek appointment of a corporate fiduciary with offices in the desired state. Therefore, if a trust permits, or does not prohibit, a change in situs, it could be possible to first move the situs of the trust to a state with a desired decanting statute and then, decant.[107] Statutory decanting can give a trustee greater certainty with regard to both the authority to decant, as well as the procedure for

99. *See Musick*, 798 S.W.2d at 629; *Sayers*, 171 S.W.2d at 551–52.

100. *See* TEX. PROP. CODE ANN. § 113.021.

101. *Id.* § 113.021(a)(6).

102. *See* M. Patricia Culler, *State Decanting Statutes Passed or Proposed*, ACTEC, http://www.actec.org/public/Documents/Studies/Culler-Decanting-Statutes-Passed-or-Proposed-03-25-2014.pdf.

103. States continue to enact or amend statutes because statutory decanting continues to rapidly evolve. For example, in 2013, Alaska repealed its long-standing statute in its entirety, and "started over" by enacting a new decanting statute. *See* ALASKA STAT. § 13.36.158. Furthermore, the Uniform Law Commission is close to finalizing a Uniform Trust Decanting Act. The latest draft of the Act may be found at the committee's web page: http://www.uniformlawcommission.com/Committee.aspx?title=Trust Decanting.

104. *See* ALASKA STAT. § 13.36.157(i)(2); MO. ANN. STAT. § 456.4-419(2)(2); N.H. REV. STAT. ANN. § 564-B:4-418(c); N.C. GEN. STAT. ANN. § 36C-8-816.1(d); S.C. CODE ANN. § 62-7-816A(e) (allowing court appointment of a special fiduciary with decanting power if all trustees are beneficiaries); S.D. CODIFIED LAWS § 55-2-15(2); VA. CODE ANN. § 64.2-778.1(D); WIS. STAT. § 701.0418(3)(c).

105. *See* ALASKA STAT. § 13.36.158(n)(1); ARIZ. REV. STAT. ANN. § 14-10819(B); 760 ILL. COMP. STAT. ANN. 5/16.4(v); MO. ANN. STAT. § 456.4-419(6); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(r); OHIO REV. CODE ANN. § 5808.18(O); S.D. CODIFIED LAWS § 55-2-15(2); TEX. PROP. CODE ANN. § 112.071(1); VA. CODE ANN. § 64.2-778.1(K).

106. *But see* discussion *infra* Part V.A.12 (regarding choice of law issues).

107. For a recent trilogy of Delaware cases supporting the proposition that it may be possible to move the situs of a trust and change the law of administration of the trust, even with fairly specific trust language regarding governing law, *see In re Peierls Family Inter Vivos Trusts*, 77 A.3d 249 (Del. 2013), *In re Peierls Family Testamentary Trusts*, 77 A.3d 223 (Del. 2013), and *In re Ethel F. Peierls Charitable Lead Unitrust*, 77 A.3d 232 (Del. 2013).

decanting. A trustee may find even greater comfort when transferring to a new situs to decant, especially if the law of the new state specifically provides that it will apply to a trust that has moved its situs to that state.

So, is statutory decanting available in Texas? As of September 1, 2013, the answer is yes![108] Sections 112.071 to 112.087 of the Texas Trust Code were enacted to expressly allow decanting and to codify the common law. In Texas, the statutory decanting power does not preclude any other rights of a trustee to distribute the trust principal in further trust, whether such right is granted by the trust agreement, common law, or court order.[109]

3. Decanting as Exercise of Power of Appointment. The earlier decanting statutes are generally an extension of the common law, which has typically provided that, absent limitations imposed by the grantor, a power of appointment held by a trustee, including a simple right to make discretionary distributions, includes the authority to make distributions subject to such terms and conditions as the trustee deems advisable.[110] Most states specifically provide that the trustee's authority to decant is considered the exercise of a power of appointment.[111] In contrast, Texas considers the trustee's power a power to distribute, rather than a power of appointment.[112]

4. Source of Trustee's Authority. Most state statutes allow a trustee to decant if the trustee has authority to invade trust principal; however, some require, at least in the case of decanting, other than for administrative changes, that the trustee have absolute power or discretion to invade trust principal. Absolute power means that the power cannot be limited by an ascertainable standard.[113] Since enactment of its decanting statute, Indiana required the trustee to have absolute power to invade principal but has amended its statute (effective July 1, 2014) to now only require that the trustee have discretion to invade principal.[114] Some states, including Texas, allow broader decanting power if the trustee has absolute discretion and allow limited decanting power if the discretion is limited.[115] In these states, if discretion is limited and the first trust grants a power of appointment to the beneficiary, then the decanted trust must also contain an identical power of appointment.[116] If decanting authority is limited to an ascertainable standard, theoretically, there are situations that would justify decanting a trust for reasons of health, education, maintenance, or support.[117]

Some states only require that the trustee have some authority, rather than absolute authority, to invade trust principal.[118] South Dakota requires the trustee to consider "whether the appointment is necessary or desirable after taking into account the purposes of the [original] trust, the terms and conditions of the [new] trust, and the consequences of making the distribution."[119] Michigan requires that the trustee have discretionary power to distribute trust principal or income, and specifically provides that a distribution power that is limited by an ascertainable standard is not a discretionary power.[120] In South Carolina, it appears that a trustee may decant even if the power to distribute trust principal and income is subject to a standard—the only limitation is that, if the trustee's discretion in the original trust is limited to an ascertainable standard, then the beneficiaries of the second trust must be the same as those of the original trust, and the same ascertainable standard must apply.[121] Wisconsin adopts a similar approach in that the trustee's power to invade trust principal or income in the second trust may not be broader than in the first

108. *See* TEX. PROP. CODE ANN. §§ 112.071–.087.

109. *See id.* § 112.081.

110. *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 19.3 (1986); *see also* 1 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 17.2 (4th ed. 1987) (explaining how to exercise the power of appointment.

111. *See* ALASKA STAT. § 13.36.158(a); ARIZ. REV. STAT. ANN. § 14-10819(C); DEL. CODE ANN. tit. 12, § 3528(c); FLA. STAT. ANN. § 736.04117(3); IND. CODE ANN. § 30-4-3-36(d); KY. REV. STAT. ANN. § 386.175(2); MICH. COMP. LAWS ANN. § 556.115a(6); NEV. REV. STAT. ANN. § 163.556(8); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(d); N.C. GEN. STAT. ANN. § 36C-8-816.1(e)(1); R.I. GEN. LAWS ANN. § 18-4-31(c); S.C. CODE ANN. § 62-7-816A(f)(1) (specifying not exercise of a general power of appointment); S.D. CODIFIED LAWS § 55-2-19; TENN. CODE ANN. § 35-15-816(b)(27)(E); VA. CODE ANN. § 64.2-778.1(E)(2); WIS. STAT. § 701.0418(8)(a) (specifying act is not exercise of a general power of appointment).

112. *See* TEX. PROP. CODE ANN. §§ 112.071–.073.

113. *See* FLA. STAT. ANN. § 736.04117(1)(a); OHIO REV. CODE ANN. § 5808.18(A)(1); WIS. STAT. § 701.0418(1)(a) (also means not limited by a specific standard but includes power to invade for best interests, welfare, comfort, or happiness).

114. *See* IND. CODE ANN. § 30-4-3-36(a).

115. *See* ALASKA STAT. §§ 13.36.157(a), (c), (d) (differing in that it is not restricted by ascertainable standard); 760 ILL. COMP. STAT. ANN. 5/16.4(c), (d) (allowing some purposes, such as welfare or happiness); TEX. PROP. CODE ANN. §§ 112.071(5)–(6), .072–.073 (explaining that full discretion means not limited *in any way*).

116. ALASKA STAT. § 13.36.157(h); 760 ILL. COMP. STAT. ANN. 5/16.4(d)(3); TEX. PROP. CODE ANN. § 112.073(3).

117. *See, e.g.*, Culp & Mellen, *supra* note 46, at 38.

118. ARIZ. REV. STAT. ANN. § 14-10819(A); S.D. CODIFIED LAWS § 55-2-15; TENN. CODE ANN. § 35-15-816(b)(27)(A).

119. S.D. CODIFIED LAWS § 55-2-15.

120. MICH. COMP. LAWS ANN. §§ 556.115a(1), (3)(b).

121. S.C. CODE ANN. §§ 62-7-816A(a), (d)(6) (2013).

trust, and if the trustee has the absolute power to invade principal, the beneficiaries of the second trust must include some or all of the beneficiaries of the first trust; otherwise, the beneficiaries must be identical.[122] In addition, Wisconsin only permits the trustee to decant if the trustee has the power to invade principal for a beneficiary who is entitled to receive income or an annuity or unitrust payment.[123] Also in Wisconsin, regardless of the distribution standard in the first trust, decanting may be done at any time if the sole purpose is to qualify or continue to qualify a beneficiary with a disability for public assistance.[124]

A trustee must have decanting power either from state law (including the common law of that jurisdiction) or from the trust agreement. The trustee's decanting power also must fall within the trustee's fiduciary duties, including the duty of loyalty. A trustee may not decant if the trust agreement expressly prohibits decanting.[125] Clients who wish to severely limit a trustee's ability to alter the terms of a trust should consider including a prohibition against decanting in the trust agreement.

Prior to any decanting, the trust agreement should be reviewed to determine whether decanting is specifically precluded or if procedures for decanting are addressed. If decanting is not specifically prohibited and specific procedures for decanting are not addressed in the trust agreement, then state law should be reviewed.

5. What the Trustee Can Decant. All states that have enacted decanting statutes allow decanting of trust principal. Some states limit decanting to trust principal.[126] A number of states appear to allow decanting of both trust principal and trust income.[127]

6. Permissible Beneficiaries of New Trust. As a general rule, the new trust must name at least some of the beneficiaries of the original trust. Therefore, in identifying who the beneficiaries of the new trust may be, the trustee must determine the beneficiaries of the old trust. A few states have used the term "proper objects of the exercise of the power" to describe who may be permissible beneficiaries of the new trust.[128] Presumably, this would include future and contingent beneficiaries of the old trust. Most states, however, simply use the term "beneficiaries" or "current beneficiaries."[129] Some states, such as Nevada, New Hampshire, North Carolina, Rhode Island, and South Carolina, specifically provide that the new trust may not include a beneficiary who is not a beneficiary of the old trust.[130] South Carolina includes the additional restriction that the interest of a beneficiary who only has a future interest in the original trust may not have that interest accelerated to a present interest.[131]

Interestingly, some states provide that the terms of the new trust may contain a power of appointment, so presumably, it would then be possible to add beneficiaries to the trust.[132] Of course, any potential tax effects from the inclusion or exercise of such a power would need to be considered.[133]

7. Tax Savings Provisions. Tax savings provisions are commonly found in the statutes. Many states include provisions to prevent loss of a marital or charitable deduction for federal or state tax purposes if the old trust qualified for the deduction.[134] In

122. WIS. STAT. § 701.0418(2)(a).

123. *Id*.

124. *Id*. § 701.0418(4)(c).

125. *See, eg*., WIS. STAT. § 701.0418(3)(a); *Cf* S.C. CODE ANN. §§ 62-7-816A(a) (allowing court approval to be sought if the trust prohibits decanting).

126. ALASKA STAT. § 13.36.157(a); DEL. CODE ANN. tit. 12, § 3528(a); FLA. STAT. ANN. § 736.04117(1)(a); 760 ILL. COMP. STAT. ANN. 5/16.4(c), (d); IND. CODE ANN. § 30-4-3-36(a); N.Y. EST. POWERS & TRUSTS LAW §10-6.6(b); R.I. GEN. LAWS ANN. § 18-4-31(a); TENN. CODE ANN. § 35-15-816(b)(27)(A); TEX. PROP. CODE ANN. §§ 112.072(a), .073(a).

127. ARIZ. REV. STAT. ANN. § 14-10819(A); KY. REV. STAT. ANN. § 386.175(2); MICH. COMP. LAWS ANN. §§ 556.115a, 700.7820a; MO. ANN. STAT. § 456.4-419(1); NEV. REV. STAT. ANN. § 163.556(1); N.H. REV. STAT. ANN. § 564-B:4-418(a); N.C. GEN. STAT. ANN. § 36C-8-816.1(b); OHIO REV. CODE ANN. § 5808.18(A)(1); S.C. CODE ANN. § 62-7-816A(a); S.D. CODIFIED LAWS § 55-2-15; VA. CODE ANN. § 64.2-778(B); WIS. STAT. § 701.0418(2)(a) (simply allowing appointment of trust assets).

128. *See* RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 19.3 (1986); *see also* DEL. CODE ANN. tit. 12, § 3528(a)(1); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(h); TENN. CODE ANN. § 35-15-816(b)(27)(A)(ii).

129. ALASKA STAT. § 13.36.157(a); ARIZ. REV. STAT. ANN. § 14-10819(A)(3); FLA. STAT. ANN. § 736.04117(1)(a)(1); 760 ILL. COMP. STAT. ANN. 5/16.4(c), (d); IND. CODE ANN. § 30-4-3-36(a)(1); KY. REV. STAT. ANN. § 386.175; NEV. REV. STAT. ANN. § 163.556(1); N.H. REV. STAT. ANN. § 564-B:4-418(a); N.C. GEN. STAT. ANN. §§ 36C-8-816.1(b), (c); TEX. PROP. CODE ANN. § 112.071(3); VA. CODE. ANN. § 64.2-778(B).

130. NEV. REV. STAT. ANN. § 163.556(1); N.H. REV. STAT. ANN. § 564-B:4-418(a); N.C. GEN. STAT. ANN. §§ 36C-8-816.1(b), (c); R.I. GEN. LAWS ANN. § 18-4-31(a); S.C. CODE ANN. § 62-7-816A.

131. S.C. CODE ANN. § 62-7-816A(d)(2).

132. ALASKA STAT. § 13.36.157(b); DEL. CODE ANN. tit. 12, § 3528(a); 760 ILL. COMP. STAT. ANN. 5/16.4(c); KY. REV. STAT. ANN. § 386.175(4)(i); MICH. COMP. LAWS ANN. § 556.115a(2)(a); NEV. REV. STAT. ANN. § 163.556(6)(a); N.C. GEN. STAT. ANN. § 36C-8-816.1(c)(8); TENN. CODE. ANN. § 35-15-816(b)(27)(F); TEX. PROP. CODE ANN. §§ 112.072(b), (c); VA. CODE ANN. § 64.2-778(B); WIS. STAT. § 701.0418(4)(b) (as long as trustee has absolute power to invade income and principal).

133. *See* discussion *infra* Part VI.A.2.b.

134. ALASKA STAT. § 13.36.158(i)(5)(A); FLA. STAT. ANN. § 736.04117(1)(a)(3); 760 ILL. COMP. STAT. ANN. 5/16.4(p); IND. CODE ANN. § 30-4-3-36(a)(3); KY. REV. STAT. ANN. § 386.175(4)(d); MICH. COMP. LAWS ANN. § 556.115a(1)(c); NEV. REV. STAT. ANN. § 163.556(2)(c); N.H. REV. STAT. ANN. § 564-

addressing tax savings, South Carolina prohibits the new trust from having a provision that will reduce or disqualify a tax deduction of the original trust or reduce qualified payments to a beneficiary under Section 2702 of the Code.[135] Several states include a provision that limits the ability to decant a trust that holds S corporation stock if the new trust is not an eligible S corporation shareholder.[136] Arizona goes a step further and provides that decanting is permissible unless it will "adversely affect the tax treatment of the trust, the trustee, the settlor or the beneficiaries."[137] A recent amendment to Tennessee's statute also incorporates broad tax savings language by prohibiting the power of the trustee to decant for specific tax reasons and also, if "any other specific tax benefit would be lost by the existence" of the authority to decant "for income, gift, estate, or [GST] tax purposes."[138] Alaska's statute now includes a similar provision as well.[139]

In many states, the current beneficiary's right of withdrawal is a concern. Some statutes limit the ability to decant if a beneficiary has a presently exercisable right of withdrawal and at a minimum, these statutes provide that the beneficiary's right will carry over to the new trust.[140] These statutes help prevent the treatment of a withdrawal right as illusory or the treatment of the beneficiary as having made a gift to the new trust.

8. Other Limitations. Several states provide that the new trust must have a distribution standard as restrictive, as or at least as restrictive as, the old trust. Some states, however, only have this requirement if the trustee has limited discretion.[141] Almost every state prohibits a trustee from decanting a trust if it will reduce a beneficiary's income, annuity, or unitrust interest in the old trust.[142]

It is common for states to provide that, in the old trust, a spendthrift provision or a provision prohibiting the grantor from amending or revoking the old trust is not sufficient to prevent the trustee from being able to decant.[143]

Some states prohibit trustees (except in narrow circumstances or with court approval) from decanting to decrease trustee liability or to provide indemnification to themselves.[144] Similar prohibitions exist to prevent decanting to change the compensation of the trustee.[145] Illinois prevents a trustee from decanting solely to change the trustee's compensation, unless a court authorizes otherwise.[146]

9. Other State Specifics. If the trustee does not have the absolute power to decant, Ohio law states that the terms of the new trust cannot materially change the interests of the beneficiaries of the old trust.[147] Therefore, Ohio law suggests that if the trustee does not have the absolute power to decant, administrative changes to the trust would still be permissible.[148] Ohio has included more specific

B:4-418(B)(3); N.C. GEN. STAT. ANN. § 36C-8-816.1(c)(4); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(n)(5); OHIO REV. CODE ANN. § 5808.18(C)(2); R.I. GEN. LAWS ANN. § 18-4-31(a)(3); TEX. PROP. CODE ANN. § 112.086; VA. CODE ANN. § 64.2-778(B); WIS. STAT. § 701.0418(3)(b).

135. S.C. CODE ANN. § 62-7-816A(d)(3).

136. ALASKA STAT. § 13.36.158(i)(5)(C); OHIO REV. CODE ANN. § 5808.18(C)(4); 760 ILL. COMP. STAT. ANN. 5/16.4(p)(2); TENN. CODE. ANN. § 35-15-816(b)(27); TEX. PROP. CODE ANN. § 112.086(c).

137. ARIZ. REV. STAT. ANN. § 14-10819(A)(5).

138. TENN. CODE. ANN. § 35-15-816(b)(27)(G).

139. ALASKA STAT. § 13.36.158(i)(5)(D).

140. ALASKA STAT. § 13.36.158(i); DEL. CODE ANN. tit. 12, § 3528(a)(4); KY. REV. STAT. ANN. § 386.175(4)(f); MO. ANN. STAT. § 456.4-419(2)(a)(6); NEV. REV. STAT. ANN. § 163.556(2)(d); N.H. REV. STAT. ANN. § 564-B:4-418(b)(4); N.C. GEN. STAT. ANN. § 36C-8-816.1(c)(6); S.C. CODE ANN. § 62-7-816A(d)(5) (stating that the new trust must have an identical right or property must remain in original trust to satisfy outstanding right); S.D. CODIFIED LAWS § 55-2-15(7); VA. CODE ANN. § 64.2-778(B).

141. ALASKA STAT. § 13.36.157(e); ARIZ. REV. STAT. ANN. § 14-10819(A)(4); KY. REV. STAT. ANN. § 386.175(4)(h); N.C. GEN. STAT. ANN. § 36C-8-816.1(c)(7); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(c)(1); S.D. CODIFIED LAWS § 55-2-15(2)(b); VA. CODE ANN. § 64.2-778(B); WIS. STAT. § 701.0418(2)(a)(2).

142. ALASKA STAT. § 13.36.158(i); ARIZ. REV. STAT. ANN. § 14-10819(A)(1), (2); FLA. STAT. ANN. § 736.04117(1)(a)(2); 760 ILL. COMP. STAT. ANN. 5/16.4(n)(1); IND. CODE ANN. § 30-4-3-36(a)(2); KY. REV. STAT. ANN. § 386.175(4)(c); NEV. REV. STAT. ANN. § 163.556(2)(b); N.H. REV. STAT. ANN. § 564-B:4-418(b)(2); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(n)(1); N.C. GEN. STAT. ANN. § 36C-8-816.1(c)(3); OHIO REV. CODE ANN. § 5808.18(C)(1)(ii); S.C. CODE ANN. § 62-7-816A(d)(3) (prohibiting decanting under stated conditions only if it would reduce or eliminate a tax deduction received); TEX. PROP. CODE ANN. § 112.073(c); VA. CODE ANN. § 64.2-778(B); WIS. STAT. § 701.0418(2)(a)(1).

143. FLA. STAT. ANN. § 736.04117(5); 760 ILL. COMP. STAT. ANN. 5/16.4(m); IND. CODE ANN. § 30-4-3-36(f); MO. ANN. STAT. § 45.4-419(2)(7); NEV. REV. STAT. ANN. § 163.556(12); N.H. REV. STAT. ANN. § 564-B:4-418(g),(h); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(m); OHIO REV. CODE ANN. § 5808.18(H); R.I. GEN. LAWS ANN. § 18-4-31(f); S.C. CODE ANN. § 62-7-816A.(f)(3); TEX. PROP. CODE ANN. § 112.084(b); VA. CODE ANN. 64.2-778(B); WIS. STAT. § 701.0418(8)(b).

144. ALASKA STAT. § 13.36.158(i)(2); 760 ILL. COMP. STAT. ANN. 5/16.4(n)(2); TEX. PROP. CODE ANN. § 112.085(4); WIS. STAT. § 701.0418(4)(d).

145. ALASKA STAT. § 13.36.158(l); 760 ILL. COMP. STAT. ANN. 5/16.4(q)(1); TEX. PROP. CODE ANN. § 112.087 (stating that decanting is not allowed if the *sole* purpose is to change compensation provisions).

146. 760 ILL. COMP. STAT. ANN. 5/16.4(q).

147. OHIO REV. CODE ANN. § 5808.18(B).

148. *See generally id.* (suggesting that, if the trustee does not have absolute power to decant, the trustee may still change the

language than most other statutes; for example, decanting cannot change a beneficiary's right to annually withdraw a percentage of the trust assets or to annually withdraw a specific dollar amount, and decanting cannot change the GST tax exemption status of the old trust.[149]

In Kentucky, the statute expressly provides that decanting cannot be done if the old trust is a charitable remainder trust.[150] At least four states expressly provide that a trust can be decanted to a "supplemental needs" or "special needs" trust.[151]

As part of its statute, Wisconsin included a laundry list of nineteen permissible reasons for decanting, including changing the age of distribution to a beneficiary, protecting a beneficiary from self-destructive behavior, adding or removing a spendthrift provision, and adding a trust protector or directed trustee and defining their powers.[152]

10. Duty to Decant? Fiduciary duties are always a concern for trustees. The more recent state statutes include language clarifying that a trustee is not obligated or under a duty to decant, although many statutes recognize that when exercising the power to decant, the trustee is acting as a fiduciary.[153] In contrast, in states where decanting is controlled by common law and not a state statute, a trustee may have a fiduciary duty to decant.

In the recent amendment to its statute, Alaska clarifies that when exercising the power to decant, a trustee has a fiduciary duty to do so as a prudent person would and in the best interests of one or more proper objects of the power.[154] Furthermore, the trustee is prohibited from decanting if there is substantial evidence that the grantor had a contrary intent and it cannot be shown that the grantor would have changed his intentions at the time of the decanting.[155]

11. Procedural Requirements. Most states require that the decanting be in writing, signed, and acknowledged by the trustee, and maintained as part of the records of the trust.[156] Even if these requirements are not set out by statute, it is prudent that the trustee take steps to document the decanting in writing, in a manner that may be made a matter of public record (for example, by an acknowledged instrument in recordable form). The trustee should maintain any such writing with the records of the trust.

Few states require court approval for decanting such as Ohio, and even in that case, the circumstances are narrow. Specifically, Ohio provides that if the trust being decanted is a testamentary trust and the decedent was domiciled in Ohio at death, the trustee must obtain court approval of the decanting.[157] Since the grantor is dead, there may be fewer tax concerns with the decanting in this instance, at least from an income tax standpoint. In South Carolina, if the original trust prohibits decanting or requires court approval in order to exercise the power, then court approval is necessary.[158] It seems surprising that even if the trust agreement prohibits decanting, it may be possible to go forward in that state.

In Illinois, the trustee or beneficiary may seek court involvement under certain circumstances.[159] Aside

trust, as along as it does not materially change the interests of the beneficiaries).

149. *Id.* § 5808.18(C)(5).

150. KY. REV. STAT. ANN. § 386.175(9).

151. ALASKA STAT. § 13.36.158(i)(1); 760 ILL. COMP. STAT. ANN. 5/16.4(d)(4) (demonstrating that the trustee has special power, although the trustee does not have absolute discretion); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(n)(1); VA. CODE ANN. § 64.2-778.1(C)(9). For an example of decanting from a trust with withdrawal rights at specific ages to a full supplemental needs trust five days before the beneficiary's birthday when he would attain the first withdrawal age, *see In re Kroll*, 971 N.Y.S.2d 863 (2013). In *Kroll*, the beneficiary was receiving Medicaid benefits and despite objections by the state's attorney general, the court found that the new trust was a third-party supplemental needs trust and no payback provision was required to be included in the new trust.

152. WIS. STAT. § 701.0418(4)(a)

153. *See, e.g.*, ALASKA STAT. § 13.36.158(g); FLA. STAT. ANN. § 736.04117(6); 760 ILL. COMP. STAT. ANN. 5/16.4(l); IND. CODE ANN. § 30-4-3-36(g); KY. REV. STAT. ANN. § 386.175(8); MO. ANN. STAT. § 456.4-419.5; NEV. REV. STAT. ANN. § 163.556(10); N.H. REV. STAT. ANN. § 564-B:418(f); OHIO REV. CODE ANN. § 5808.18(J) (demonstrating that, if a trustee acts reasonably and in good faith, the trustee will be presumed to have acted according to the terms and purposes of the trust and in the interests of the beneficiaries); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(l) (demonstrating that decanting must be done to serve the best interests of the beneficiaries and a prudent person standard will apply); N.C. GEN. STAT. ANN. § 36C-8-816.1(g); R.I. GEN. LAWS ANN. § 18-4-31(g); S.C. CODE ANN. § 62-7-816A(h); TEX. PROP. CODE ANN. §§ 112.072(e), 112.073(f), 112.083; VA. CODE ANN. § 64.2-778.1(H); WIS. STAT. § 701.0418(7) (also not liable to beneficiary for any related loss unless did not appoint in good faith).

154. ALASKA STAT. § 13.36.158(e).

155. *Id.*

156. *See, e.g.*, ALASKA STAT. §§ 13.36.159(b), (i); DEL. CODE. ANN. tit. 12, § 3528(b); FLA. STAT. ANN. § 736.04117(2); 760 ILL. COMP. STAT. ANN. 5/16.4(r); IND. CODE ANN. § 30-4-3-36(c); KY. REV. STAT. ANN. § 386.175(7)(a); NEV. REV. STAT. § 163.556(7); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(j); N.C. GEN. STAT. ANN. § 36C-8-816.1(f)(1); OHIO REV. CODE ANN. § 5808.18(D); R.I. GEN. LAWS ANN. § 18-4-31(b); S.C. CODE ANN. § 62-7-816A(g)(1); S.D. CODIFIED LAWS § 55-2-18; TENN. CODE ANN. § 35-15-816(b)(27)(B); TEX. PROP. CODE ANN. § 112.075; VA. CODE ANN. § 55-548.16:1(F); WIS. STAT. § 701.0418(5)(a).

157. *See* OHIO REV. CODE ANN. § 5805.16(k).

158. S.C. CODE ANN. § 62-7-816A(h).

159. 760 ILL. COMP. STAT. ANN. § 5/16.4(k).

from one narrow exception, however, no state requires the trustee to obtain beneficiary consent; although, most states require the trustee to give notice to the beneficiaries prior to decanting.[160] In Nevada, if trust property is designated for a specific beneficiary pursuant to the terms of the old trust, but after decanting, the property will no longer be designated for that beneficiary, the trustee must obtain consent.[161]

12. Choice of Law Issues. When decanting involves changing the situs of a trust, choice of law issues must be considered. The Restatement (Second) of Conflict of Laws (Conflict Restatement) provides that when construing or administering a trust holding personal property, the law of the state designated in the trust agreement controls.[162] The designated state's law will apply as long as the state has a substantial relationship to the trust and its law does not violate any strong public policy of the state with which the trust has the most significant relationship.[163] The law governing the construction of a trust and the law governing the administration of a trust may be different.[164] According to the Conflict Restatement, if the trust is silent as to the law governing the construction of the trust, the trust may be construed based on a number of different laws including: the law of the state governing the administration of the trust, the law of the trust's domicile, the law of the state with which the grantor had the most contacts, or even the law that the grantor would believe to apply such as where the grantor was domiciled.[165] However, as indicated in one of the recent *Peierls* cases, if a court ruling is obtained to establish governing law of a particular state, any future change to the governing law may require action by that court.[166]

B. The Texas Statute.[167] As mentioned above, the Texas statutory decanting provisions can be found in Sections 112.071 through 112.087 of the Texas Trust Code.[168] Because the Texas statute has many features in common with other state statutes,[169] the foregoing discussion incorporates references to the Texas decanting statute. The following topics are of special note for Texas.

1. The Trustee's Power. Texas law provides that if a trust agreement does not prohibit decanting, an authorized trustee may distribute or decant the principal of one trust to a second trust.[170] The distribution must be set out in writing, signed, and acknowledged by the authorized trustee and filed with the records of both trusts.[171] An authorized trustee is one who is not a grantor of a trust and who has the authority to distribute principal to or for the benefit of the current trust beneficiaries.[172] A trustee's power to distribute differs depending on whether the trustee has full power or limited power to distribute principal pursuant to the trust agreement.[173] Full discretion means that a trustee's power may not be limited in any way.[174] Therefore, *any* restriction on distribution powers results in limited discretion.[175] These limitations would include not only an ascertainable standard but also standards such as welfare and happiness.[176] If more than one trustee is serving and one co-trustee has full discretion while the other co-trustee has limited discretion, the co-trustee with full discretion may act alone and exercise the broader decanting power provided under the statute.[177] Although no duty is imposed on a trustee to exercise the decanting power and no "impropriety" is imposed

160. *See* ALASKA STAT. § 13.36.159(b), (d), (f) (stating that the settlor may exempt the notice requirement to a beneficiary in the trust, or else the 30-day notice may be waived and additionally indicating that a trustee must provide notice to a living settlor and anyone with fire and hire power); FLA. STAT. ANN. § 736.04117(4); 760 ILL. COMP. STAT. ANN. 5/16.4(e); IND. CODE ANN. § 30-4-3-36(e); KY. REV. STAT. ANN. § 386.175(7)(b); MICH. COMP. LAWS ANN. § 700.7820a(7) (requiring 63-day notice that may be waived and notice to living settlors); MO. ANN. STAT. § 456.4-419.3; N.C. GEN. STAT. ANN. § 36C-8-816.1(f); N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(j)(2) (requiring notice to others); OHIO REV. CODE ANN. § 5808.18(F); R.I. GEN. LAWS ANN. § 18-4-31(d) (requiring 60-day notice); S.C. CODE ANN. § 62-7-816A(g)(2) (requiring 90-day notice to qualified beneficiaries that may be waived); TEX. PROP. CODE ANN. § 112.074 (stating that no consent or court approval is required if all current and presumptive remainder beneficiaries are given notice); VA. CODE ANN. § 55-548-16:1(G) (requiring notice to others); WIS. STAT. § 701.0418(5) (also requiring notice to any trust protector, directing party, and if living, the settlor; if not seeking court approval, 30-day notice that may be waived).

161. NEV. REV. STAT. ANN. § 163.556(2)(e).

162. RESTATEMENT (SECOND) OF CONFLICT OF LAWS: TRUSTS §§ 268(1), 272(a) (1971).

163. *See id.* § 270(a). For an example of a court in a divorce matter refusing to follow the choice of law provision in a trust document, *see* the Utah case of *Dahl v. Dahl*, 2015 UT 23 (Utah 2015). For other recent cases illustrating this proposition, *see* note 107 *supra*.

164. *See id.*

165. *See id.* §§ 268(2), 270(b), 272(b).

166. *In re Peierls Family Testamentary Trusts*, 77 A.3d 223 (Del. 2013).

167. On January 28, 2015, HB 1029 was filed in the Texas Legislature and contains proposed revisions to the Texas decanting statutory provisions. A copy of the relevant excerpts from the Bill is attached as Exhibit A.

168. TEX. PROP. CODE ANN. § 112.071-.087

169. When reviewing the various statutes, the influences of Illinois and Ohio are evident.

170. *Id.* §§ 112.072–.073.

171. *Id.* § 112.075.

172. *Id.* § 112.071(1).

173. *Id.* §§ 112.072, .073.

174. *Id.* § 112.072(a).

175. *See id.* § 112.073.

176. *Id.* § 112.071(5).

177. *Id.* § 112.079.

on the trustee for not exercising the power, when the trustee exercises any decanting power, he must do so "in good faith, in accordance with the terms and purposes of the trust, and in the interests of the beneficiaries."[178]

2. Full Discretion vs. Limited Discretion and Types of Beneficiaries. A trustee with limited discretion may still decant, but because of restrictions provided in the current statute as to what must stay the same after decanting, the power appears to be limited to only administrative types of changes.[179] The current, the successor, and the presumptive remainder beneficiaries of the first trust must be the same in the second trust, and if a class of beneficiaries is included in the first trust, they must also be in the second trust.[180] In addition, distribution provisions and powers of appointment granted in the first trust must be identical in the second trust.[181]

Note some of the unique terminology regarding beneficiaries in the current Texas statute.[182] There are three types of beneficiaries to consider: current beneficiaries, presumptive remainder beneficiaries, and successor beneficiaries.[183] A current beneficiary is one who is receiving or is eligible to receive a distribution of income or principal on a particular date.[184] A presumptive remainder beneficiary is one who, on a particular date, would be eligible to receive a distribution if the trust terminated or if the interests of all current eligible beneficiaries ended without causing the trust to terminate.[185] A successor beneficiary is any other beneficiary, but does not include a potential appointee of a power of appointment.[186]

In contrast to a trustee with limited discretion, if a trustee has full discretionary power to distribute principal, many options exist.[187] A trustee may distribute all or part of the trust principal to the trustee of the second trust, and the second trust may include one or more of the beneficiaries of the first trust who are eligible to receive income or principal.[188] The statute even gives the trustee the ability to grant a power of appointment, inter vivos or testamentary, to any current beneficiaries who are eligible to receive the trust principal outright and the appointees of such power may include beneficiaries who were not beneficiaries of the first trust.[189]

3. Notice, Consent, and the Right to Object. No grantor or beneficiary consent or court approval is needed as long as the written, statutory notice, with copies of the first and second trusts, is given at least thirty days prior to the proposed decanting to all current and presumptive remainder beneficiaries.[190] The beneficiaries to receive notice are "determined as of the date the notice is sent."[191] Written notice is given by registered or certified mail, return receipt requested, or by personal delivery.[192] If a charity is a beneficiary of any type, whether named or not, or if the trust has a charitable purpose and no charity is named, notice must also be given to the Texas Attorney General.[193] For minor beneficiaries the notice is sent to a parent, and if a beneficiary is subject to a court-appointed guardian or conservatorship, the notice is sent to the guardian or conservator.[194] A beneficiary may waive notice, but only if the waiver is in writing.[195] Other exceptions to the notice requirement are: (1) if the beneficiary cannot be located after reasonable diligent search, (2) the beneficiary is unknown, and (3) if an ancestor of a beneficiary has been given notice, the ancestor has a similar interest in the trust, and no apparent conflict exists.[196]

With one exception as described below, court approval is not required to decant. Nevertheless, a trustee may petition a court to order the distribution.[197] Beneficiaries may also petition a court to approve, modify, or deny a decanting.[198] The one exception to court approval is that if the attorney general makes a

178. *Id.* §§ 112.072(e), .073(f), .083.
179. *See generally id.* § 112.073 (decanting when trustee has limited discretion).
180. *Id.* § 112.073(b), (d).
181. *Id.* § 112.073(c), (e).
182. *See id.* §§ 112.071, .073.
183. *Id.* § 112.071 (defining the different types of beneficiaries).
184. *Id.* § 112.071(3).
185. *Id.* § 112.071(7).
186. *Id.* § 112.071(10).
187. *See generally id.* § 112.072 (decanting when trustee has full discretion).
188. *Id.* § 112.072(a). Although the second trust may be for the benefit of any one or more members of the three classes of beneficiaries, one clause in the current statute slightly muddies the waters. A literal reading seems to suggest that a successor beneficiary or a presumptive remainder beneficiary may only be included if eligible to receive income or principal of the trust. This author believes the phrase "who are eligible to receive income or principal from the trust" is superfluous. *Id.* Otherwise, it seems that to be included, successor and presumptive remainder beneficiaries would have to be current beneficiaries.
189. *Id.* § 112.072.
190. *Id.* § 112.074(a), (f).
191. *Id.* § 112.074(b).
192. *Id.* § 112.074(f)(7).
193. *Id.* § 112.074(c). Note how these provisions differ in the case of a judicial termination or modification. See discussion *supra* at Part IV.B.2.
194. *Id* . § 112.074(d).
195. *Id* . § 112.074(e)(3), (f)(7).
196. *Id.* § 112.074(e).
197. *Id.* § 112.078(a).
198. *Id.* § 112.078(b).

written objection to the trustee within thirty days after receiving statutory notice of the decanting, the trustee is prohibited from moving forward unless court approval is obtained.[199] If an objection is made by anyone other than the attorney general, the rules are slightly different. In that case, if the trustee receives a written objection before the proposed effective date of the decanting, the trustee or the beneficiary may seek a court order to continue with or prevent the decanting.[200] In the latter case, making an objection could rise to the level of a question of standing. A beneficiary is given permission to file a petition if the trustee receives a written objection prior to the proposed date of the decanting.[201] Under the current statute, it appears then that if the objection is not received prior to the proposed date, a beneficiary may not have standing to file a court action. Whereas a trustee must send notice to beneficiaries at least thirty days prior to the decanting, a trustee must receive any objection prior to the proposed date.[202] It is possible that a beneficiary may have far fewer than thirty days to consider the proposal, so he or she should make sure to evaluate the proposal and respond timely if there is an objection.

4. Limits to Decanting. Even if an authorized trustee appears to otherwise have the power to decant, the Texas statute incorporates statutory exceptions to the power. Many of these exceptions are tax related and are specifically identified, but a catch-all is included so that the decanting is prohibited if it would prevent a contribution from qualifying for or reduce any "tax benefit for income, gift, estate or [GST] tax purposes under the Internal Revenue Code of 1986."[203] In addition to tax-related limitations, a trustee may not decant if it will "reduce, limit, or modify a beneficiary's current, vested right" to a mandatory distribution of income or principal, an annuity or unitrust interest, or a right of withdrawal.[204] Furthermore, a trustee may not decant in order to materially limit a trustee's fiduciary duty, decrease the liability of a trustee or provide indemnification to the trustee, or eliminate a person's fire and hire power over the authorized trustee.[205] In addition, a trustee may not decant solely to change the trustee compensation provisions, but if decanting is done for any other reason, the compensation provisions may also be revised to reflect current, reasonable compensation limits under state law.[206] Finally, the ultimate catch-all in the current statute: an authorized trustee may not decant if it will "materially impair the rights of any beneficiary."[207]

199. *Id.* § 112.078(c).
200. *Id.* § 112.078(b).
201. *Id.*
202. *Id.*
203. *Id.* § 112.086(a)(5).
204. *Id.* § 112.085(1).
205. *See id.* § 112.085(3)–(5).

VI. TAX ISSUES IN DECANTING AND TRUST MODIFICATIONS

A. General Tax Issues. The foregoing discussion focused primarily on the state law issues surrounding trust modifications and decanting. Equally important, however, are the tax issues that might arise. As mentioned above, decanting is not defined in the Internal Revenue Code or Treasury Regulations. Beginning in 2011, the IRS adopted a no-ruling policy which continues to today with respect to certain issues relating to decanting arrangements, including the issue of whether the decanting of a trust results in a taxable gift.[208] The IRS generally will continue to issue rulings in situations where the decanting does not result in any change in beneficial interests or in the applicate perpetuities period. Since Notice 2011-101 was issued, comments were submitted to the IRS by several organizations, including ACTEC, ABA's Section of Taxation, the State Bar of Texas Tax Section, the New York State Bar's Tax Section, and Bessemer Trust; however, at this time, the IRS has not given a date as to when published guidance can be expected. Until the IRS publishes guidance and case law develops, the following discusses the potential tax issues that practitioners should consider when advising clients about decanting or other trust modification.[209]

1. Income Tax Issues. In most cases, decanting from one trust to another, trust modifications, and trust combinations should present minimal, if any, tax consequences to the trust or the trust beneficiaries.[210]

a. Distributions and DNI. If trust assets are decanted from one trust to another trust, one possibility is that the decanting will be treated as a trust modification rather than a termination of the initial trust; consequently, both trusts will be treated as

206. *Id.* § 112.087.
207. *Id.* § 112.085(2).
208. *See* Rev. Proc. 2015-3, § 5.01(20), 2015-1 I.R.B. 129.
209. This article discusses tax issues from a federal standpoint. Advisors, however, should also consider any state tax issues that may arise. In addition, decanting a domestic trust to a foreign trust or vice versa is beyond the scope of this article.
210. *See* Mickey R. Davis, *Income Taxation of Trusts and Estates*, ST. B. TEX., 33RD ANNUAL ADVANCED ESTATE PLANNING AND PROBATE COURSE (June 10–12, 2009), http://www.texasbarcle.com/Materials/Events/8183/111153.htm (discussing income tax issues associated with trusts).

the same trust for income tax purposes.[211] No income tax consequences would be recognized to either trust because of the decanting. Instead, the result would be that the surviving trust will report all income, expenses, and distributions for the entire year.[212]

A second possibility follows the general rule that any distribution from a trust will carry with it a portion of the trust's distributable net income (DNI).[213] Trust distributions are generally treated as coming first from the trust's current income, with tax-free distributions of "corpus" arising only if distributions exceed DNI.[214] If distributions are made to multiple beneficiaries, DNI is allocated to them pro rata.[215] If a trust terminates, the IRS will carry out current income along with any unused capital losses, net operating losses, and expenses incurred in excess of income.[216] However, when two trusts combine or merge, no provision of the Code provides that the combination of trusts is tax-free. Therefore, the IRS may treat the terminating trust's distribution as carrying out its DNI, unused losses, and excess deductions to the surviving trust.[217] In other words, the new trust would receive taxable income to the extent of the old trust's DNI, and the old trust would receive a corresponding distribution deduction.

b. Grantor Trusts. For income tax purposes, grantor trust treatment is determined by Subpart E of Subchapter J of the Internal Revenue Code.[218] The IRS treats trust property held in a grantor trust as being owned by the grantor for federal income tax purposes.[219] A transfer of trust property from one grantor trust to another grantor trust should have no federal income tax effect. In the case of sales transactions between a grantor and a grantor trust, no federal income tax effect will result.[220] More recently, in Revenue Ruling 2007-13, the IRS made it clear that if a grantor trust transfers a life insurance policy owned by the trust to another grantor trust, the IRS will deem the grantor as the owner of the policy for the transfer-for-value rules, so that there will be no negative income tax consequences.[221] Thus, the act of transferring, merging, or decanting the assets of a grantor trust to another grantor trust, the latter merely being the transfer of assets from one trust to the other, should have no income tax effect.[222]

When a grantor trust loses its grantor trust status, the IRS deems the grantor as having transferred ownership of the trust property to the trustee of the trust, and a taxable disposition of the trust property by the grantor occurs.[223] The fact that a disposition of trust property occurs does not necessarily mean that the disposition has any effect for federal income tax purposes. Rather, as the court made clear in *Madorin v. Commissioner*, the grantor trust rules operate to determine whether the grantor is the owner of the trust property for federal income tax purposes.[224] However, other provisions of the Internal Revenue Code, such as the partnership tax rules, must be reviewed to determine if there is any federal income tax effect upon a disposition of the trust property.[225]

Therefore, the mere transfer of trust property from a grantor trust to a non-grantor trust, through decanting or otherwise, should not, in and of itself, cause a realization event for federal income tax purposes. Instead, provisions of the Internal Revenue Code, other than the grantor trust tax rules, may cause a realization event for federal income tax purposes.

In contrast, if a non-grantor trust becomes a grantor trust through decanting or otherwise, there should be no realization event in any case.[226] By their terms, Sections 671 through 677 of the Internal Revenue Code can cause a trust that is a non-grantor trust at one point in time to be treated as a grantor trust at a later time.[227] The portion rules in these sections are examples of such events. For example, if a trust allows the use of trust income to pay premiums on life insurance policies, insuring the life of the grantor or the grantor's spouse, to the extent the premiums are so used, that portion of the trust will be a grantor trust.[228]

In addition, marriage is enough to make an otherwise non-grantor trust become a grantor trust.[229] For example, a trust that allows distributions of income to a grantor's friend does not make the trust a grantor trust, but if the grantor marries the friend, the trust will then be treated as a grantor trust.[230] In addition, a

211. *See* PLRs 200736002 (Sept. 7, 2007); 2000723014 (Feb. 5, 2007), and 200607015 (Nov. 4, 2005).
212. *See id.*
213. *See* IRC §§ 651, 661.
214. *See id.* § 661.
215. *See id.*
216. *See id*. § 642(h).
217. *See id.* §§ 642(h), 661(a).
218. *See id.* §§ 671-79.
219. *Id.* § 671.
220. *See* Rev. Rul. 85-13, 1985-1 C.B. 184.
221. Rev. Rul. 2007-13, 2007-1 C.B. 684.
222. *See id.*
223. *Madorin v. Comm'r*, 84 T.C. 667, 678-80 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; Treas. Reg. § 1.1001-2(c), ex. 5.
224. *See Madorin*, 84 T.C. at 668.
225. *Id.*; *see, e.g.*, IRC § 741.
226. Rev. Rul. 85-13, 1985-1 C.B. 184.
227. IRC §§ 671–77.
228. *Id.* § 677(a).
229. *Id.* § 672(e).
230. *See id.* § 677(a).

trust is not a grantor trust if a grantor: (1) establishes a trust, (2) names his or her friend as trustee, and (3) gives broad discretionary authority regarding distributions to the trustee.[231] If the grantor subsequently marries the trustee, however, the trust will then become a grantor trust.[232] As shown by these examples, and as can be seen throughout the grantor trust rules, relatively benign actions can cause an otherwise non-grantor trust to become a grantor trust.[233] In addition, in Chief Counsel Advice 200923024, the IRS ruled that for federal income tax purposes, the conversion of a non-grantor trust to a grantor trust is not a transfer of property that requires the recognition of gain by the owner.[234] Based on the foregoing, the mere act of a conversion from a non-grantor trust to a grantor trust through decanting should not cause a federal income tax realization event.

c. Gains. Treasury Regulation Section 1.1001-1(a) provides that gain from the conversion of property into cash, or gain from the exchange of property that is materially different in kind or extent, is treated as income.[235] The issue is whether property is being sold or disposed of in exchange for property that is materially different. In *Cottage Savings Association v. Commissioner*, the Supreme Court found that properties are materially different if their owners "enjoy legal entitlements that are different in kind or extent."[236] In certain situations, the IRS might argue that a decanting or trust modification may be treated as a distribution followed by an exchange of interests among the beneficiaries, resulting in recognized gain for income tax purposes.[237]

In Private Letter Ruling 200231011, the taxpayer asked the IRS to rule on the tax consequences of a proposed trust modification.[238] Under the terms of a testamentary trust, the testator's grandson was to receive a fixed dollar amount each year during his life, with the remainder interest passing to various charities. The trust was later restructured to provide for annual income distributions in accordance with a performance chart. Subsequently, disputes arose regarding the administration of the trust. Under the terms of a settlement, the charities would receive an immediate distribution of corpus in termination of their interest. The remaining amount would continue in trust for the grandson, providing him a 7% unitrust amount, plus distribution of principal as needed for his reasonable support. On his death, the remaining corpus would be distributed in accordance with the grandson's general testamentary power of appointment. In citing *Cottage Savings*, the IRS ruled that "[a]n exchange of property results in the realization of gain or loss under Section 1001 [of the Code] if the properties exchanged are materially different."[239] The IRS then compared the proposed modification to the modifications in two other cases.[240] The first case, *Evans v. Commissioner* involved the exchange of an income interest in a trust for an annuity which the court concluded was a realization event. The second case, *Silverstein v. United States* found that the exchange of an interest in a trust for a right to specified annual payments from the remainder beneficiary did not result in a realization event because the "taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust."[241] The IRS determined that the proposed settlement at issue "more closely resembled the situation in *Evans* than in *Silverstein* because the grandson was currently entitled to trust income subject to a floor and ceiling, but under the proposed settlement he would receive annual unitrust payments and could receive additional discretionary distributions. The IRS stated, "[e]ven assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required" under the current terms of the trust.[242] "He also would not be limited by the . . . maximum annual payment ceiling" and "payments would be determined without regard to trust income."[243] Therefore, the "[g]randson's interest in the modified trust would entail legal entitlements different from those" under the current trust agreement, and as a result, the modification would be treated as a realization event for federal income tax purposes.[244]

231. *See id.*
232. *See id.* § 672(e).
233. *See id.* §§ 671–77.
234. CCA 200923024 (June 5, 2009).
235. Treas. Reg. § 1.1001-1(a).
236. *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554, 564 (1991).
237. *See* Rev. Rul. 69-486, 1969-2 C.B. 159.
238. PLR 200231011 (Aug. 2, 2002).
239. *Cottage Savings Ass'n v. Comm'r*, 499 U.S. at 560.
240. *See* PLR 200231011 (Aug. 2, 2002); *see also Evans v. Comm'r*, 30 TC 798 (1958); *Silverstein v. U.S.*, 419 F.2d 999 (7th Cir. 1969).
241. *See* PLR 200231011.
242. *Id.*
243. *Id.*
244. *Id.*; *see also* PLR 200736002 (Sept. 7, 2007) (finding division of a trust into three separate trusts, on a pro rata basis, did not result in gain or loss because the new trusts were not materially different, even though, in the new trusts, the trustees would be different).

In Private Letter Ruling 200743022, the IRS considered whether decanting assets from old trusts to new trusts and the merger of the trusts' assets would cause gain or loss recognition in a situation where both state law and the trust agreement authorized the decanting.[245] Because the decanting was to occur as a result of the trustees' discretionary authority according to state law and the trust agreement, and not as a result of the beneficiaries' exchange of trust property, the IRS ruled that no gain or loss would be recognized by any of the trusts or the beneficiaries. The exercise of the trustees' discretionary authority and the lack of involvement by the beneficiaries prevented an analysis pursuant to Section 1001 of the Code.[246]

d. Basis Disregarded. If Section 1001 of the Code applies because of the beneficiary's involvement in the decanting or modification, then, Section 1001 provides a special rule for determining gain or loss from the disposition of a term interest in property.[247] Under Section 1001(e), in determining gain or loss from the disposition of a term interest, generally, the adjusted basis of the interests determined under Sections 1014 (inheritance), 1015 (gift), or 1041 (transfers between spouses) of the Code is disregarded. A "term interest in property" for purposes of Section 1001(e) means a life interest, an interest for a term of years, or an income interest in a trust.[248] An exception to this rule applies where the sale or disposition is part of a transaction in which the entire interest in property is transferred.[249] In Private Letter Ruling 200231011 (discussed above), after concluding that the grandson's interest, as modified, would entail different legal entitlements from those he originally possessed, thus resulting in gain recognition, the IRS explained that under Section 1001(e)(1) of the Code, the portion of the adjusted uniform basis assigned to the grandson's interest in the trust should be disregarded because it was a term interest. Accordingly, the grandson was required to recognize gain on the entire amount received.[250]

e. Negative Basis Assets. For beneficiaries, because of Section 1001 of the Code and *Crane v. Commissioner*, a concern may arise if a trustee decants property that has debt in excess of its basis, or an interest in a limited partnership or limited liability company with a negative capital account.[251] In *Crane*, the taxpayer sold property that was subject to nonrecourse debt. The Supreme Court held that the amount realized on the sale included not only any cash or other property received, but also the amount of taxpayer's debt that was discharged as a result of the sale.[252] In the partnership context, Section 752(d) of the Code provides that when a taxpayer sells a partnership interest, any partnership liabilities are treated the same as any other liabilities in the context of a sale or exchange of property. In the trust context, Section 643(e) of the Code provides that upon the distribution of trust property, a beneficiary will receive a carryover basis in the property, adjusted for any gain or loss recognized on the distribution. Section 643(e) further provides that gain or loss may be recognized on the distribution, if a trustee elects. Unfortunately, no authority provides an answer as to whether a distribution of trust property that is subject to debt will cause recognition of gain or loss, as would be the case with the sale or exchange of other property under *Crane* and related authority, or whether no gain or loss would be recognized unless an election is made by a trustee pursuant to Section 643(e).[253] Hopefully, published guidance will answer this question.

2. Gift Tax Issues

a. General Gift Issues. Can the IRS argue that decanting, trust combinations, and the like give rise to taxable gifts? As discussed above, Section 2512(b) of the Code provides that where a transfer of property is made for less than adequate and full consideration, the amount in excess of fair consideration will be treated as a gift. The notion that a gift arises as a result of decanting or a trust modification may be especially important in situations in which the beneficiary must consent to the change, or where the change results from the settlement of litigation.

On the one hand, a transfer of property by an individual in compromise and settlement of threatened estate litigation is a transfer for full and adequate consideration in money or money's worth and, thus, is not a gift for federal gift tax purposes.[254] Private Letter Ruling 8902045 involved a settlement of a will contest and considered the issue of whether transfers pursuant to the settlement were subject to gift tax.

245. PLR 200743002 (Oct. 26, 2007).
246. *Id.*
247. IRC § 1001.
248. *Id.* § 1001(e)(2).
249. *Id.* § 1001(e)(3).
250. PLR 200231011 (Aug. 2, 2002).
251. *See* IRC § 1001; *Crane v. Comm'r*, 331 U.S. 1 (1947).
252. *Crane*, 331 U.S. at 14.
253. As discussed above, when transferring assets from one grantor trust to another grantor trust, the basic rule is that transfers between two grantor trusts are disregarded for federal income tax purposes.
254. *See Lampert v. Comm'r*, 15 T.C.M. 1184 (1956); *see also Righter v. U.S.*, 258 F. Supp. 763, 766 (8th Cir. 1966), *rev'd and remanded on other grounds*, 400 F.2d 344 (8th Cir. 1968); PLR 9308032 (Nov. 30, 1992).

The IRS stated that intra-family settlements should not result in shifts between the parties' economic rights, that the economic values of the parties' claims should be determined "with appropriate allowances for uncertainty," and that "differences may be justified on the basis of compromise."[255]

On the other hand, where there is no adequate consideration for the settlement agreement, gift tax consequences will arise.[256] For example, if a remainder beneficiary agrees to decanting or the termination of a trust and gives up his or her interest in the trust in favor of the income beneficiary, the remainder beneficiary may be treated as having made a gift, subject to gift tax.[257] As a basis for having a dispute to settle, commentators have suggested filing a court action.[258] To avoid a potential IRS argument of substance over form, it is important to assess whether a true controversy exists. The gift tax implication may arise, notwithstanding the fact that the value of the foregone interest may be difficult to value.[259] This difficulty in valuation could make it possible to assign a relatively low value to the gift. Despite a resulting shift of beneficial interests, the IRS has not found a gift to arise when a trust is reformed to conform to the grantor's original intent.[260]

Since decanting is based on a trustee's discretion, gift tax issues can arise if a trust beneficiary is serving as a trustee and exercises the discretion to decant. Treasury Regulation Section 25.2511-1(g)(2) provides that if a trustee is a trust beneficiary and transfers trust property, the transfer will be a taxable gift by the trustee-beneficiary unless the trust agreement limits the fiduciary power by an ascertainable standard.[261] Even more certainty is provided in Treasury Regulation Section 25.2511-1(g)(1).[262] This regulation provides that if a trustee, who is not a beneficiary, distributes property to another beneficiary of the trust, no taxable gift will occur.[263] Therefore, if a beneficiary is the trustee, the better practice is to only have an independent trustee exercise discretion to decant.

Similarly, if a beneficiary consents to decanting, such as through providing a receipt and release, an argument exists that the beneficiary is exercising control over the assets that could give rise to a taxable gift. Again, the purpose for the decanting becomes important—such as when the decanting will shift a beneficial interest to different beneficiaries—to determine whether negative tax consequences may result. In a fairly recent private letter ruling, a GST-grandfathered trust was modified to include legally adopted issue and descendants in the definitions of issue and descendants.[264] Under the facts, some of the grantor's children and grandchildren were legally adopted. The IRS ruled that, as a result of the modification, each issue of the grantor's child made a gift of their respective future interest in the trust's income and principal to the adopted issue who were now beneficiaries of the trust. Interestingly, the IRS also ruled that no loss of the trust's GST-grandfathered status would occur because the modification did not shift beneficial interests to lower generation beneficiaries or extend the term of the trust.[265] Likewise, the concern about gift tax consequences to a beneficiary is especially true in the case of a trust that is set to terminate at a specific date or age and decanting is done to continue the trust. Furthermore, if the beneficiary consents to the decanting, the IRS may argue that the beneficiary is a grantor of the new trust pursuant to Treasury Regulation Section 1.671-2(e)(1).

b. Exercise, Release, or Lapse of General Power of Appointment. The exercise, release, or lapse of a general power of appointment is deemed a transfer of property by the individual possessing the power.[266] To avoid gift tax implications when trusts are decanted or modified, one must determine whether trustees who are also beneficiaries possess general powers of appointment over trust property and whether the decanting or modification of the trust results in the creation, exercise, release, or lapse of a general power of appointment.

If a beneficiary of a trust exercises a power of appointment to create a new trust and the termination date of the new trust can be extended beyond the perpetuities period provided in the original trust, the exercise of the power of appointment during the life of the beneficiary may be treated as a taxable gift by the powerholder, or at the death of the beneficiary may result in inclusion in the estate of the powerholder.[267]

255. PLR 8902045 (Jan. 13, 1989).
256. *See Nelson v. U.S.*, 727 F. Supp. 1357; PLR 9308032 (Nov. 30, 1992).
257. *See* Rev. Rul. 84-105, 1984-2 C.B. 197.
258. *See* Steve R. Akers & Philip J. Hayes, *Estate Planning Issues With Intra-Family Loans and Notes*, ST. B. TEX., 36TH ANNUAL ESTATE PLANNING AND PROBATE COURSE (June 27–29, 2012), http://www.texasbarcle.com/Materials/Events/9220/141972.pdf.
259. *See id; see also* PLR 9451049 (Sept. 22, 1994).
260. *See* PLR 200318064 (May 2, 2003).
261. Treas. Reg. § 25.2511-1(g)(2).
262. *See generally* Treas. Reg. § 25-2511-1(g)(1) (discussing when gift tax is applicable to a transfer).
263. *See id.*
264. PLR 200917004 (Apr. 24, 2009).
265. *Id.*
266. IRC § 2514(b).
267. *Id.* § 2514(d).

This is commonly referred to as the "Delaware Tax Trap." Again, if decanting is only exercised by an independent trustee, these issues should not arise.[268] As is common when exercising a power of appointment which results in property passing to a new trust, language may be included in the new trust to prohibit triggering of the Delaware Tax Trap.

3. Estate Tax Issues. Does the grantor run any risks in participating in the decanting or modification of an irrevocable trust, either by agreement or by judicial proceeding? In particular, one might be concerned that the state law basis for decanting or trust modification would be used to find that the grantor somehow retained a power of change or revocation when he or she created the otherwise-irrevocable trust. Treasury Regulation Section 20.2038-1(a)(2) provides, however, that Section 2038 of the Code (power to revoke) does not apply if a power can be exercised only with the consent of all parties having an interest (vested or contingent) in the trust, and if the power adds nothing to the rights of the parties under local law.[269] Therefore, decanting and modifications involving the grantor's participation should not implicate estate tax issues for the grantor.[270] For beneficiaries, there may be an issue with estate inclusion as described above in the context of the Delaware Tax Trap, or if it is shown that the beneficiary had such control over the trust assets as to fall within Section 2036 or 2038 of the Code.[271] Of course, if the new trust grants a beneficiary a general power of appointment over the trust assets, the assets will be included in the beneficiary's estate pursuant to Section 2041 of the Code.[272]

4. Generation-Skipping Transfer Tax Issues. The GST-tax area is the one area where there is a distinction in the Treasury Regulations between powers of appointment and trust decanting. Specifically, the regulations address these differences by providing different safe harbors that may be used to protect the exempt status of grandfathered trusts.[273]

a. Grandfathered Trusts. A trust that was irrevocable on September 25, 1985 is exempt from the generation-skipping transfer tax, so long as no additions to or modifications of the trust are made after that date.[274] Actual or constructive additions to one of these "grandfathered" trusts make a proportionate amount of distributions from and terminations of interests in property in the trust subject to the GST tax.[275] Releases, exercises, or lapses of a power of appointment are examples of constructive additions.[276] In ruling on GST matters, the IRS generally focuses on whether a trust modification results in changes in the value of beneficiaries' interests, beneficial enjoyment, or timing of the enjoyment (even an acceleration of the receipt of property by a skip person, which would result in exposing the trust property to transfer taxation more rapidly than if the grandfathered trust held the property for the full term). If such a change occurs, the trust will lose its grandfathered status.[277] In contrast, other administrative changes do not appear to jeopardize the grandfathered status.[278] As a result, one must be extremely careful in modifying or decanting any trust created prior to September 25, 1985, and the GST tax implications should be considered before proceeding with any modification or decanting.

As discussed above, for other purposes, decanting has been likened to the exercise of a power of appointment, and many state statutes treat decanting as the exercise of a power of appointment. However, also as mentioned above, for GST tax purposes, the Treasury Regulations distinguish between decanting (although this term is not used) and special powers of appointment in that the regulations provide for different safe harbors for each.[279] For powers of appointment, the regulations focus on whether the exercise of a power of appointment will cause a delay in vesting of a grandfathered trust.[280] Specifically, Treasury Regulation Section 26.2601-1(b)(1)(v)(B) provides that if the exercise of a power of appointment will delay the vesting of the trust beyond a life in

268. *See id*. § 2514(b).
269. *See* also PLR 201233008 (Mar. 28, 2012).
270. *See id.*; *see also* PLRs 200919008, 200919009, and 200919010 (Jan. 12, 2009).
271. *See* PLR 201233008 (Mar. 28, 2012).
272. *See* IRC § 2041 (West 1942) (amended 1976).
273. *See* Treas. Reg. § 26.2601-1(b).
274. *See id*. Any trust that was irrevocable on September 25, 1985, the date deemed by the IRS to be the first public notice of the effective date of the tax, is one type of effective date trust. Tax Reform Act of 1986 ("TRA '86"), Pub. L. No. 99-514, 100 Stat. 2085, § 1433(b)(2)(A). In addition to trusts irrevocable on September 25, 1985, wills and revocable trusts in existence on October 22, 1986, if the decedent died before January 1, 1987, and trusts created by a person under a mental disability on October 22, 1986, who does not regain competence before death also were deemed exempt. *Id.*; TRA '86 § 1433(b)(2)(C).
275. *Id*. § 26.2601-1(b)(1)(v).
276. *See id.*
277. *See* PLR 8851017 (Dec. 23, 1988).
278. *See, e.g.*, PLRs 8902045 (Jan. 13, 1989); 8912038 (Mar. 24, 1989); 9005019 (Feb. 2, 1990); 9849007 (Dec. 4, 1998); and 200607015 (Feb. 17, 2006).
279. *See* Treas. Reg. §§ 26.2601-1(b)(4)(i)(A), -(b)(4)(i)(D)(1).
280. *See id*. § 26.2601-1(b)(1)(v)(B)(1).

being at the date of the creation of the grandfathered trust plus 21 years or 90 years from the date of creation of the trust, the exercise will be treated as an addition to the trust, and the trust will lose its GST exempt status. The key is the exercise of the power of appointment, not the release or lapse of the power.[281]

For decanting a grandfathered trust, the Treasury Regulations have two safe harbors.[282] The first one is found in Section 26.2601-1(b)(4)(i)(A) and provides that decanting will not cause a grandfathered trust to lose its GST exempt status if: (1) the terms of the trust or local law at the time the trust became irrevocable authorized the trustee to make distributions to a new trust, without the consent or approval of any beneficiary or court, and (2) the terms of the new trust do not extend the vesting of any beneficial interest in a way that would suspend or delay the vesting, absolute ownership, or power of alienation beyond a specific perpetuities period.[283] Because the first state statute was not effective until 1992, which is well after the possible effective date of a grandfathered trust, the trustee would have to look to common law for decanting authority if the trust terms do not authorize the decanting.[284] Note that beneficiary consent and court approval cannot be obtained in order to fall within this safe harbor. In addition, if the requirements of this safe harbor are met, it is possible to use decanting to shift a beneficial interest down generations, as well as up or across generations. Also, it is possible to extend the vesting of the trust for a term longer than that provided in the original trust, unlike the next safe harbor.

The second safe harbor applicable to decanting is found in Treasury Regulation Section 26.2601-1(b)(4)(i)(D)(1) and provides that a trust modification will not cause a grandfathered trust to lose GST exempt status if the modification is: (1) valid under state law, (2) will not shift a beneficial interest to a beneficiary who occupies a generation lower than a beneficiary who held the beneficial interest prior to the modification, and (3) the modification does not extend the time for vesting of a beneficial interest beyond the perpetuities period provided for in the original trust.[285] Unlike the first safe harbor, if the requirements of the second safe harbor are met, the decanting cannot shift a beneficial interest down generations, but may only shift beneficial interests up or across generations. However, it may be possible to use a statute for decanting under this safe harbor since there is no requirement that the statute existed at the time that the trust became irrevocable.[286]

Regulations under both safe harbors seem to provide that mere administrative changes to a grandfathered trust through decanting are acceptable and will not cause a loss of grandfathered status.[287] It seems to follow that if decanting of a trust does not change the grandfathered or GST tax exempt status of either the old trust or the new trust, the inclusion ratio of the old trust should carry over to the new trust.[288]

b. Non-Grandfathered Trusts. As noted above, the safe harbors provided in the Treasury Regulations apply to grandfathered trusts. Although no guidance has been published, the IRS appears to have taken the position that the Treasury Regulations applicable to grandfathered trusts should also apply to non-grandfathered trusts.[289] If this is the case, a decanting or other modification that follows the requirements of either of the safe harbors discussed above should preserve the GST exempt status, and the inclusion ratio of the old trust should carry over to the new trust.[290] In addition, a decanting or modification that is purely administrative in nature should preserve the GST exempt status.[291]

c. Loss of GST Exempt Status. It is important to carefully work through the issues when decanting or modifying a trust in order to preserve GST exempt status; however, it is unclear what the result will be if GST exempt status is lost. Commentators seem to agree that loss of GST exempt status does not mean that all future distributions from the trust will be subject to GST tax.[292] At one point, the IRS took the view that the loss of GST exempt status through modification or reformation would cause a gift by the beneficiaries to occur.[293] A year later, the IRS revised

281. *Id.*
282. *See id.* §§ 26.2601-1(b)(4)(i)(A), -(b)(4)(i)(D)(1).
283. *Id.* § 26.2601-1(b)(4)(i)(A).
284. In *Morse v. Kraft*, 992 N.E.2d 1021 (Mass. 2013), prior to decanting to the new trust, the trustee obtained a declaratory judgment (from the court of highest jurisdiction in the state, no less) that the old trust gave him authority to distribute assets of the old trust to the new trust without court or beneficiary approval, thereby falling within this first safe harbor.
285. Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1).
286. *See id.* §§ 26.2601-1(b)(4)(i)(A), (b)(4)(i)(D)(1).
287. *Id.* §§ 26.2601-1(b)(4)(i)(D)(1), -1(b)(4)(i)(E), exs. 6, 10.
288. *See generally id.* § 26.2601-1(b)(4)(i) (noting the default nature of the trust's tax-exempt status).
289. PLRs 200743028 (May 29, 2007); 200919008 (Jan. 12, 2009); and 201233008 (Mar. 28, 2012).
290. *Compare* Treas. Reg. § 26.2601-1(b)(4)(i), *with* PLRs 200743028 (May 29, 2007), 200919008 (Jan. 12, 2009), and 201233008 (Mar. 28, 2012).
291. *See* Treas. Reg. §§ 26.2601-1(b)(4)(i)(D)(1), (b)(4)(i)(E).
292. *See* HARRINGTON, PLAINE & ZARITSKY, GENERATION-SKIPPING TRANSFER TAX: ANALYSIS WITH FORMS ¶ 7.06[3] (2d ed. 2001).
293. PLR 9448024 (Aug. 31, 1994); *see also* PLR 9421048 (Mar. 3, 1994).

its position to conclude that when a trust loses its GST exempt status, the grantor will be the transferor.[294] Therefore, it appears that if the trust loses its GST exempt status and the grantor is treated as the transferor, then the "normal" rules regarding non-exempt trusts, at least as to denying a GST tax benefit, would apply to those beneficiaries who would only receive the benefit because of the decanting or modification. It is unclear how GST exemption is applied in this circumstance, or whether the "move-down" rule of Code Section 2651(e) would apply. For example, distributions made to skip persons who otherwise would not have been entitled to distributions prior to the loss of GST exempt status would be subject to the GST tax after the loss of exempt status.

VII. CONCLUSION

With the possibility to decant under common law—and as more states enact decanting statutes—it is clear that advisors should become familiar with decanting as a means to modifying a trust. The continuing expansion of the ability to decant makes it clearer that the term irrevocable trust does not mean that the trust cannot be changed. Therefore, when advising grantors, estate planners may want to discuss whether it is appropriate to give the trustee the ability to decant or to expressly prohibit the trustee from exercising decanting authority. In addition, when advising trustees, there may be situations where it would be important for the trustee to consider decanting as an option and to document any conclusions, keeping in mind that a trustee's fiduciary duties overlay any action by a trustee. As always, the terms of the trust, state statutes or common law, and tax law must be reviewed to determine the limitations to any changes that may be made.

294. PLR 9522032 (Mar. 3, 1995) (amending its ruling in PLR 9421048 (Mar. 3, 1994)).