AN ANALYSIS OF
THE TAX EFFECTS OF DECANTING

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Editors' Synopsis: The power to decant is a power held by the trustee of
an irrevocable trust and allows the trustee to invade the corpus of the
trust—in whole or in part—in favor of another trust for the benefit of one,
some, or all of the original trust's beneficiaries. Any number of events can
give rise to a decanting, but commonly it results from the need or desire to
remove some sort of adversity, inefficiency, or lack of benefit that becomes
apparent under the original trust. This article examines the income, gift,
estate, and generation-skipping transfer tax consequences of decanting
and concludes that, when a trustee exercises the power in accordance
with its fiduciary obligations and the limitations on its power to make
distributions in further trust, no adverse tax consequences to the trustee or
the beneficiaries ought to result.

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I. INTRODUCTION

Most states permit judicial modification of a trust, at least in certain circumstances. Yet, a judicial modification of an irrevocable trust may not be entirely satisfactory because the requirement to respect the settlor’s intent, at least to some degree, may constrain the court’s authority. In addition, a judicial modification that requires beneficiary approval may have adverse tax consequences. If, however, the trustee could pay all or part of the corpus over to a different trust, that may remove the adversity, inefficiency, or lack of benefit with the least number of adverse consequences, including adverse tax consequences or opposition by one or more of the beneficiaries. In some cases, the drafter will expressly authorize the trustee or another to make such a payment or to “decant” the trust. But many trust instruments do not expressly contain that authority, although one may contend that a power to “apply” a distribution for a beneficiary’s benefit includes a power to pay trust assets over to another trust for the beneficiary. By statute, a growing number of states expressly authorize a trustee, at least in certain circumstances, to pay the corpus—and, in some cases, the income—of one trust over to another.

By analogy to the pouring of a liquid, such as wine, from one container to another, the power of a trustee to invade the corpus of one trust in favor of another trust is commonly referred to as “decanting.” For purposes of this article, a decanting power is a power exercisable by the trustee of an irrevocable trust—under the common law, the express grant of authority of a governing instrument, or an applicable state statute, and in all cases without prior court approval or prior beneficiary consent—to invade the corpus of the original trust, in whole or in part, in favor of another trust for the benefit of one, some, or all of the beneficiaries of the original trust. This article discusses the potential tax effects of decanting.

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1 See, e.g., Fla. Stat. Ann. § 736.04115(2) (West 2010) (“In exercising discretion to modify a trust under this section: (a) The court shall exercise discretion in a manner that conforms to the extent possible with the intent of the settlor, taking into account the current circumstances and best interests of the beneficiaries.”).

II. BACKGROUND

For many reasons, a determination may be made that the express terms of a trust created by will or other instrument are incorrect, inappropriate, or insufficient to accomplish the settlor’s desired goals or to avoid potentially adverse effects. The laws of several states permit a change in the terms of a trust for a number of reasons and by a number of means including reformation, modification, and construction. Fourteen states have adopted statutes that permit a change in the disposition or administration of trust property by granting a power, held by trustees under common law, that permits a trustee to invade the corpus of the trust in favor of another trust.4

Phipps v. Palm Beach Trust Co.5 contains the first discussion and application of decanting by an American court. In Phipps, the Supreme Court of Florida held that a trustee could invade trust property by paying it over to another trust for the beneficiary.6 That decision seems consistent with the common law throughout the United States and suggests that a decanting power likely is held by trustees under the common law of all states.7 No court has held that such fiduciary power does not exist under common law.

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3 See, e.g., FLA. STAT. ANN. § 736.04115(2)(a); I.R.C. § 2055(e)(3)(B) (“For purposes of this paragraph, the term ‘qualified reformation’ means a change of a governing instrument by reformation, amendment, construction, or otherwise . . . .”).


5 See 196 So. 299 (1940).

6 See id. at 301.

7 See also Wiedenmayer v. Johnson, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969). Wiedenmayer concerned an indirect decanting, however, in that the trustees exercised their power of invasion in favor of the beneficiary contingent on the beneficiary’s agreement to transfer the property in further trust. See id. at 535. The court concluded the transfer was in the beneficiary’s best interests, describing those best interests as follows:

The expression is not limited to a finding that distribution must be to the son’s best “pecuniary” interests. His best interests might be served without regard to his personal financial gain. They may be served by the peace of mind, already much disturbed by matrimonial problems, divorce and the consequences thereof, which the new trust, rather than
New York was the first state to enact decanting legislation. Although amended since its original enactment in 1992, the original version of the New York statute essentially allowed a trustee who had “absolute” authority to invade the trust corpus for a beneficiary (hence, under a broad standard as opposed, for example, to one limited to health, education, maintenance, and support) to pay the corpus over to another trust for that beneficiary. The statute’s legislative history shows that it is consistent with and declaratory of existing common law.

III. INVASION POWER AS POWER OF APPOINTMENT

A trustee’s power to invade the corpus of a trust is analogous to a power of appointment for property law purposes. Indeed, as a general rule, the holder of a power of appointment, similar to a trustee with decanting power, may appoint the property in further trust. This suggests that if a decanting power is similar to a power of appointment, a trustee who may invade the corpus of a trust may pay it to a different trust for the benefit of the beneficiary or beneficiaries for whom it may be invaded, unless the instrument provides otherwise. As mentioned above, in what is perhaps the only case

the old contingencies provided for in his father’s trust indenture, will engender. Of what avail is it to rest one’s “best interests” on a purely financial basis, and without regard to the effect upon a man’s mind, heart and soul, if the end result would produce a wealthier man, but a sufferer from mental anguish? Id. at 536.

8 See N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002); see also Alan S. Halperin & Lindsay N. O’Donnell, Modifying Irrevocable Trusts: State Law and Tax Considerations in Trust Decanting, in 42 HECKERLING INSTITUTE ON ESTATE PLANNING 13-1, 13-3 (Tina Portuondo ed., 2008).

9 See 1 AUSTIN WAKEMAN SCOTT, WILLIAM FRANKLIN FRATCHER & MARK L. ASCHER, SCOTT AND ASCHER ON TRUSTS § 3.1.2 (5th ed. 2006).

10 If the trustee invades for his own benefit, then the power of invasion may constitute a general (estate taxable) power of appointment under Internal Revenue Code sections 2514(c) and 2041(b). See I.R.C. §§ 2514(c), 2041(b). The power to invade for one’s own benefit (that is, to withdraw property from the trust) may cause the powerholder to be the owner of the trust for purposes of section 671 so that the income, deductions, and credits against tax of the trust are attributed to the powerholder. See id. § 678(a). If the power is held in a fiduciary capacity, however, section 678 may not apply. See Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, A Beneficiary as Trust Owner: Decoding Section 678, 35 ACTEC J. 106 (2009).

11 See generally SCOTT ET AL., supra note 9 (stating that the trend is to construe the language conferring a power of appointment with increasing liberality and to hold that the donee of the power has broad discretion to exercise the power).

12 See, e.g., RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 19.14 (2011) (“Except to the extent that the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment in any form, including
dealing expressly with the issue, the Florida Supreme Court, in *Phipps*, held that the trustee could invade a trust by paying the corpus to a new trust.\textsuperscript{13}

Nevertheless, when New York adopted its statute, no developed law about decanting existed there or in any other state except Florida. Even though the Florida Supreme Court had ruled that a trustee could transfer property from one trust to another pursuant to an absolute power of invasion, Florida adopted a decanting statute to clarify and specify many aspects of decanting authority and its exercise. Hence, a state legislature may prefer to adopt a decanting statute rather than rely on general principles of property law. Alaska, Arizona, Delaware, Florida, Indiana, Missouri, Nevada, New Hampshire, North Carolina, Ohio, South Dakota, Tennessee, and Virginia have all enacted legislation similar to the New York law,\textsuperscript{14} which appears to reflect an acknowledgment of the statute’s utility. Due to heightened appreciation for the authority to distribute to new trusts, many practitioners also now include decanting provisions in their trust forms.

The Alaska, Arizona, Delaware, Florida, Nevada, New York, and North Carolina statutes all expressly state that the power to invade in further trust is a special power of appointment.\textsuperscript{15} Delaware, Florida, Nevada, and North Carolina also expressly state that the power is not exercisable in favor of the trustee, the trustee’s estate, the trustee’s creditors, or the creditors of the trustee’s estate.\textsuperscript{16} The restriction aims to avoid having the power to decant

one in trust and one that creates a power of appointment in another, that only benefits permissible appointees of the power.”). Indeed, the Illinois rule goes further:

Unless the contrary intent is evidenced by the terms of the instrument creating or limiting a power of appointment, a donee of a power of appointment may . . . (6) if the donee could appoint outright to the object of a power, make appointments that create in the object of the power additional powers of appointment and such powers of appointment may be exercisable in favor of such persons or entities as the person creating such power may direct, even though the objects of such powers of appointment may not have been permissible objects of the power of appointment pursuant to which such powers are created.

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\textsuperscript{13} See *Phipps* v. Palm Beach Trust Co., 196 So. 299, 301 (1940).

\textsuperscript{14} See statutes cited supra note 4.


treated as a general power of appointment under section 2041 of the Internal Revenue Code (Code).

In *Phipps*, the Florida court cited section 17 of *Restatement of Trusts* for the proposition that if a trustee has a special power of appointment—a power to appoint among the members of a specified class—then whether the trustee can effectively appoint a trustee for members of the class depends on the terms of the power vested in him.\(^{17}\) Accordingly, the court concluded as follows: "The general rule gleaned from the foregoing and other cases of similar import is that the power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent."\(^{18}\)

Because the trustee holds the power to decant, it is by definition a fiduciary power. Comment c to section 75 of *Restatement (Third) of Trusts* draws a distinction between powers held in a fiduciary capacity and those held for the powerholder’s own benefit.\(^{19}\) The discussion echoes the reporter’s notes on section 64, which also draw a distinction between a personal power that the trustee may exercise for the benefit of the power’s donee and a fiduciary power that the trustee must exercise for the purpose for which the settlor created it.\(^{20}\) The reporter’s notes on section 64 also indicate that if the powerholder’s power is personal, then the trustee’s only duty is to ascertain whether the attempted exercise is within the terms of the trust.\(^{21}\)

Section 11.1 of *Restatement (Second) of Property: Donative Transfers* took the position that a person with power of appointment could hold it in a fiduciary capacity\(^{22}\) and may exercise it in further trust.\(^{23}\) Notwithstanding, the foregoing distinction between personal and fiduciary powers, which section 17.1 of *Restatement (Third) of Property: Wills and Other Donative Transfers* invokes,\(^{24}\) section 17.1 supports the notion that a trustee with a

\(^{17}\) See *Phipps*, 196 So. at 301.

\(^{18}\) Id.

\(^{19}\) See *Restatement (Third) of Trusts* § 75 cmt. c(1)–(2) (2007).

\(^{20}\) See id. § 64 reporter’s notes.

\(^{21}\) See id.

\(^{22}\) See *Restatement (Second) of Prop.: Donative Transfers* § 11.1 cmt. a (1986).

\(^{23}\) See id. § 19.3.

\(^{24}\) See *Restatement (Third) of Prop.: Wills & Other Donative Transfers* § 17.1 cmt. g (2011). ("A fiduciary distributive power is a power of appointment (a nongeneral power), but it is not a discretionary power of appointment. In the case of a discretionary power of appointment, . . . the donee may exercise the power arbitrarily as long as the exercise is within the scope of the power. . . . In the case of a fiduciary distributive power, the fiduciary’s exercise is subject to fiduciary obligations . . . .")
power to invade the corpus of a trust may do so by paying the corpus over to another trust for the beneficiary. 25

The donee of a power of appointment seems to have no affirmative duty to act in good faith and could exercise a power of appointment arbitrarily, for example, to exclude a person from beneficial enjoyment for personal reasons. 26 On the other hand, fiduciary duties would preclude a fiduciary from acting in a similar manner. Instead, these duties would hold fiduciaries to a minimum standard of good faith, with an obligation to act consistently with the terms of the trust and the interests of the beneficiaries. 27

All of this simply means that power of appointment may be an incomplete phrase to use when referring to a trustee’s power to distribute in further trust because, without more, the phrase might connote a lack of fiduciary duties surrounding its exercise. However, it does not imply a change in the law concerning whether a trustee has such authority.

IV. USES OF DECANTING

Initially, the New York statute allowed decanting only if the trustee received the consent of either the beneficiaries or a court having jurisdiction over the trust. 28 New York has deleted that requirement. The New York courts have permitted the use of decanting for the following reasons:

Fiduciary distributive powers include a trustee’s power to distribute principal to or for the benefit of an income beneficiary, or for some other person, or to pay income or principal to a designated beneficiary, or to distribute income or principal among a defined group of beneficiaries. Unlike a discretionary power of appointment, a fiduciary distributive power does not lapse upon the termination of the fiduciary’s appointment (by death, resignation, or otherwise), but survives in a successor fiduciary. Nevertheless, a fiduciary distributive power, like a discretionary power of appointment, cannot be validly exercised in favor of or for the benefit of someone who is not a permissible appointee (see § 19.14, Comment j) and is subject to the Rule Against Perpetuities under the same rules applicable to a trust or other donative disposition of property created by the exercise of a discretionary nongeneral power of appointment (see § 27.1, Comment j(3)).

25 See id. § 17.1 cmts. f, g.
26 See RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. a (2003) (“A trustee’s discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power.”).
27 See UNIF. TRUST CODE § 105 (amended 2005), 7C U.L.A. 428 (2006) (prohibiting a trust instrument from exonerating a trustee’s duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries).
28 See N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002).
1. Protecting the tax treatment of a trust;\textsuperscript{29}
2. Granting a beneficiary a power of appointment, presently exercisable or otherwise;\textsuperscript{30}
3. Reducing administrative costs;\textsuperscript{31}
4. Altering trusteeship provisions such as the identity or manner of appointing fiduciaries;\textsuperscript{32}
5. Extending the termination date of a trust;\textsuperscript{33}
6. Converting a nongrantor trust to a grantor trust or the reverse;\textsuperscript{34}
7. Changing a trust’s governing law;\textsuperscript{35}
8. Dividing trust property to create separate trusts;
9. Reducing potential liability;\textsuperscript{36}

\textsuperscript{29} See Matter of Ould, N.Y.L.J., Nov. 28, 2001, at 21 (N.Y. Sur. Ct. 2001) (permitting the trustees to appoint the trust estate consisting of a second-to-die insurance policy to a new trust, thereby eliminating the “Crummey power” of withdrawal of one of the insureds).

\textsuperscript{30} See Phipps v. Palm Beach Trust Co., 196 So. 299, 301 (1940) (holding that granting a beneficiary a power of appointment is consistent with a trustee’s decanting power because the trustee could accomplish the same result by paying the principal of the trust directly to the beneficiary who could then give or bequeath the property to anyone in the world or expend it for his or her own benefit).


\textsuperscript{32} See Matter of Klingenstein, N.Y.L.J., Apr. 20, 2000, at 33 (N.Y. Sur. Ct. 2000) (changing limitations on number of individual trustees, powers to remove and replace trustees, requirement for a corporate trustee, designation of successor trustees, and ability of corporate trustee to appoint a successor).

\textsuperscript{33} See Hazon v. Hazon, N.Y.L.J., Apr. 11, 2000, at 30 (N.Y. Sur. Ct. 2000) (permitting a trustee to extend a trust for a beneficiary’s lifetime); see also Matter of Dornbush, 627 N.Y.S.2d 232 (Sur. Ct. 1995) (discussing the corpus of an irrevocable trust subject to New York law, which was to end at the death of the first to die of the grantor and the beneficiary and was paid to a new Florida trust for the beneficiary’s lifetime to protect the trust assets from the beneficiary’s potential creditors).

\textsuperscript{34} See Chief Couns. Mem. 200923024 (Dec. 31, 2008) (holding that the mere conversion of a nongrantor trust to a grantor trust is not a transfer for income tax purposes requiring the recognition of gain).

\textsuperscript{35} See Matter of Dornbush, 627 N.Y.S.2d 232 (Sur. Ct. 1995) (allowing two irrevocable trusts subject to New York law to pay over assets to substantially identical Florida trusts in order to protect the trusts’ assets from New York real property transfer gains taxes).

\textsuperscript{36} See Matter of Kaskel, 620 N.Y.S.2d 217 (Sur. Ct. 1994) (allowing the trustees of several family trusts, which included spendthrift provisions, to terminate the existing trusts and pay over assets to new trusts without spendthrift provisions so that the beneficiaries could assign their interests in distressed real estate properties from the trusts to corporations, followed by an invasion of the principal of the trusts in favor of the corporations).
10. Converting a trust into a supplemental needs trust to permit a beneficiary to qualify for certain governmental benefits;\textsuperscript{37} and

11. Making trust interests spendthrift or the reverse.\textsuperscript{38}

Nevertheless, in \textit{In re Estate of Mayer},\textsuperscript{39} the court denied relief in the case of a testamentary trust that authorized the independent trustee “to distribute principal ‘in [his] sole and absolute discretion, [as he] may deem necessary or advisable for the health, support, maintenance and education of any person or persons who may at such time be a person or persons eligible to receive income from the trust. . . .’”\textsuperscript{40} The court concluded that “absolute discretion . . . connotes a standard that is unconstrained except by the implicit requirements of reasonableness and good faith.”\textsuperscript{41} The court held that the proposed invasion was essentially a request to invade for estate planning purposes (the petitioners alleged that it would permit the reduction of taxes) and “outside the parameters [of the standard] established by the testator even when reviewed with the greatest possible leniency.”\textsuperscript{42}

Other common uses of decanting include the following:

1. addressing changed circumstances, such as changes in applicable fiduciary law or changes in family circumstances or dynamics;

2. modifying administrative provisions, such as restrictions on investment powers or on authority to create a “directed trust”; or

3. correcting a drafting error without going to court.

\textbf{V. COMMON DECANTING PROVISIONS}

Although not all state decanting statutes are alike, some have common or parallel provisions. Some statutes allow decanting only if the trustee’s power to invade the trust is absolute.\textsuperscript{43} Others permit invasions even if the trust specifies a fixed (that is, ascertainable) standard for invasion.\textsuperscript{44} At least


\textsuperscript{38} See \textit{Matter of Rockefeller}, N.Y.L.J., Aug. 24, 1999, at 28 (N.Y. Sur. Ct. 1999) (permitting a committee of individuals with discretionary distribution authority over a trust to pay trust assets to a new trust to protect the trust principal by providing a spendthrift restraint).

\textsuperscript{39} 672 N.Y.S.2d 998 (Sur. Ct. 1998).

\textsuperscript{40} Id. at 999.

\textsuperscript{41} Id. at 1000 (internal quotation marks omitted).

\textsuperscript{42} Id. at 1001.


\textsuperscript{44} See, e.g., \textit{Del. Code Ann. tit. 12 § 3528 (Supp. 2010).
one statute requires that the invasion standard in the trust to which the trust assets are decanted be the same as it was in the invaded trust.\textsuperscript{45} Most statutes expressly require that trustees may not eliminate an income interest and must preserve the income when decanting.\textsuperscript{46} South Dakota’s statute, however, suggests that a trustee could eliminate a fixed income interest through decanting.\textsuperscript{47} Some statutes provide that trustees cannot use the decanting power to extend the term of the trust beyond the applicable rule against perpetuities.\textsuperscript{48}

VI. TAX ISSUES OF DECANTING

Tax consequences are almost always possible upon the transfer of property. These consequences might include the following:

1. Income tax when, among other situations, the property is sold or exchanged for another asset;\textsuperscript{49}

2. Gift tax when the property is transferred, or deemed to have been transferred, during the transferor’s lifetime for less than full and adequate consideration in money or money’s worth;\textsuperscript{50}

3. Estate tax when the transfer is made, or deemed to have been made, at death;\textsuperscript{51}

4. Generation-skipping transfer (GST) tax when the property is transferred to a “skip person”;\textsuperscript{52} and

5. Other taxes, such as state or local transfer taxes\textsuperscript{53} and property taxes affected by changes in the value of the property transferred.\textsuperscript{54}

Little developed law exists regarding the tax consequences of decanting. Detailed guidance would be helpful to taxpayers trying to discern decanting’s tax effects, but, in its absence, making analogies to other transfers about which the law is more developed may be an appropriate substitute.

\textsuperscript{45} See ALASKA STAT. § 13.36.157 (2008).
\textsuperscript{46} See id.; FLA. STAT. ANN. § 736.04117; N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002).
\textsuperscript{47} See S.D. CODIFIED LAWS § 55-2-15 (Supp. 2011).
\textsuperscript{48} Compare N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 with ALASKA STAT. § 13.36.157.
\textsuperscript{49} See I.R.C. §§ 61, 1001.
\textsuperscript{50} See id. § 2512.
\textsuperscript{51} See id. § 2031; Estate of DiMarco v. Comm’r, 87 T.C. 653 (1986), acq. in result 1990-2 C.B. 1 (holding that a transfer took effect at death when an incomplete gift had been made during lifetime and continued to be treated as incomplete until the transferor died).
\textsuperscript{52} See I.R.C. §§ 2601, 2612(a).
\textsuperscript{54} See, e.g., CAL. CONST. ART. 13A (West 1996).
A. Similar to Exercise of a Special Power of Appointment

Decanting may be analogized most closely to the exercise of a special power of appointment over trust property or to the discretionary distribution of property from a trust by the trustee to a beneficiary. Indeed, each of the statutes essentially is premised on the idea that decanting is part of making a discretionary distribution from the trust for (rather than to) one or more of the trust beneficiaries.

In fact, as a general matter, federal tax law does not seem to distinguish, for gift or estate tax purposes, between a power held in a fiduciary capacity and one held in a nonfiduciary capacity.\(^{55}\) For example, a power to withdraw property from a trust for one’s own benefit is a general (gift and estate taxable) power of appointment whether held in a fiduciary or nonfiduciary capacity.\(^{56}\) Similarly, a power to distribute trust property only to persons other than the powerholder, his estate, his creditors, or creditors of his estate is a special (nongeneral) power of appointment under section 2514.\(^{57}\) However, a power held in a fiduciary capacity to withdraw income or principal from a trust for the powerholder may not cause the attribution of the income, deductions, and credits of the trust to the powerholder under section 678, as it would if held in a nonfiduciary capacity.\(^{58}\)

A more explicit comparison of a nonfiduciary power of appointment and a power to decant occurs under the Treasury Regulations regarding GST tax "grandfathering." Treasury Regulation section 26.2601-1(b)(1)(i) provides that an irrevocable trust (and distributions from it) created before September 26, 1985, is exempt from GST tax.\(^{59}\) In addition, the trust remains grandfathered even if a beneficiary exercises a special power of appointment, as long as the power is not exercised in a manner that may suspend the vesting of ownership of the trust property beyond the end of the historic rule against perpetuities—a life in being plus twenty-one years—or, if it may, beyond a term of ninety years from the inception of the trust that granted the special power.\(^{60}\)

Apparently, at least under the common law, nothing restricts the class of measuring lives that may be selected for purposes of the rule against perpetuities.

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55 See I.R.C. § 2514(c).
57 See I.R.C. § 2514(c).
58 See Blattmachr et al., supra note 10, at 109.
tities if the members of the class are ascertainable. An otherwise grandfathered trust also remains exempt from the tax if the trustee has the power to pay the trust property over to another trust or to keep it in the same trust, provided that the trustee does not exercise the power in a manner that may suspend the vesting beyond the time period specified in the regulations (that is, any life in being plus twenty-one years or, if the trust does not comply, ninety years) and that the original trust instrument or state law in effect at the time of the trust’s creation granted the trustee’s power to pay the corpus over to another trust or to keep it in trust.

Although the GST tax regulations do not explicitly treat decanting as a power of appointment, it seems that the regulations should treat powers of appointment and the power to decant similarly. In fact, the trustee’s power to decant—which, when exercised (subject to the vesting time discussed above), will not cause loss of grandfathering—must have been contained in or authorized by state law applicable to the original trust. Granting a beneficiary a power of appointment by any means after September 25, 1985, with respect to a grandfathered trust in which a state law applicable to the original trust neither contained nor authorized the conferral of authority to grant the power may cause the loss of grandfathering if the power could be exercised to postpone the vesting of ownership of trust property beyond the time otherwise provided in the original trust. However, because decanting pow-

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61 At common law, the only restriction on the class of persons that could be used as measuring lives for purposes of complying with the rule against perpetuities was that the lives used in the instrument of transfer had to be identifiable so that proof of the deaths of the individuals could be obtained. See Thelusson v. Woodford, (1805) 32 Eng. Rep. 1030 (Ch.); RESTATEMENT (SECOND) OF PROPER TRANSFERS § 1.3 reporter’s note (1983); JOHN CHIMAN GRAY, THE RULE AGAINST PERPETUITIES § 217 (4th ed. 1942). English law permitted a class consisting of all the lineal descendants of Queen Victoria, which at the time was thought to include approximately 120 known descendants. See In re Villar, [1927] 1 Ch. 243 (Eng.). In Private Letter Ruling 200928013, however, the holder of a power of appointment quoted the language of Treasury Regulation section 20.2041-1(c)(1) in prohibiting any trust funded by the exercise of a special power of appointment from postponing or suspending vesting for a period, measured from date of creation of original trust, that extends beyond “any life in being at the date of creation plus 21 years.” Priv. Ltr. Rul. 200923013, at 3. The Service ruled that this language preserved the grandfathering, which is remarkable since the language would seem to encompass a class consisting of everyone in the world living on the date of creation of the trust. See id. at 4.


63 See id. § 26.2601-1(b)(4)(i)(D)(1) (“A modification of the governing instrument of an exempt trust (including a trustee distribution) will not cause an exempt trust to be subject to the [GST] tax provisions . . . if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest [in the trust] prior to the modification, and
ers arguably inhere in common law, they arguably existed at the creation of the trust. Hence, it seems that the GST tax regulations treat a special power of appointment and a decanting power similarly.\(^{64}\)

An alternative analogy to how trustees make distributions from a trust also may be appropriate to consider. In some situations, the Service will tax discretionary distributions made by a trustee in the same manner as a distribution by a trustee mandated by the exercise of a power of appointment held by a beneficiary. Both transfers, as a general rule, will be deemed to consist of the trust’s distributable net income (DNI), as defined in section 643(a).\(^{65}\) In other circumstances, however, the transfers will not be the same.

For example, if a trustee chooses to distribute $100 worth of property to a beneficiary, that distribution—even if made with non-cash assets—will not ordinarily cause the trust to recognize gain or loss.\(^{66}\) On the other hand, if a person other than the trustee exercises a power of appointment mandating that the trustee distribute $100 worth of assets to a beneficiary, the distribution would cause the trust to realize gain or loss if a non-cash asset were distributed in satisfaction of the right to the $100.\(^{67}\)

Because, in general, a distribution by reason of decanting is discretionary, the distribution likely would not be treated as requiring the distribution of a fixed dollar amount, as in a pecuniary distribution mandated by the exercise of a power of appointment held by someone other than the trustee. Accordingly, the income tax treatment should be similar to that applicable to the exercise of a trustee’s discretionary distribution authority.

B. Income Tax

As a general rule, any distribution from a trust is deemed to consist of the trust’s DNI to the extent of the lesser of the amount distributed or the amount of DNI, which is the trust’s taxable income for the year of distribu-

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\(^{64}\) Treasury Regulations section 26.2642-6(h) appears to permit treating trusts created by a decanting that does not take the form of a qualified severance as separate trusts on a prospective basis if state law would treat the new trusts as separate. See generally Carol A. Harrington et al., Breaking Up Is No Longer Hard to Do: Final GST Tax Qualified Severance Regulations, 107 J. Tax’n 273 (Nov. 2007); Carol A. Harrington et al., Breaking Up May Get Even Easier to Do—Proposed GST Tax Severance Regulations, 107 J. Tax’n 331 (Dec. 2007).


\(^{66}\) See Treas. Reg. § 1.661(a)-2.

\(^{67}\) See id.
tion as specially computed under section 643(a). Not all trust distributions are deemed to consist of DNI, or at least not all of the DNI. Exceptions exist for distributions in satisfaction of certain bequests of specific sums and specific property, and to the extent the DNI is allocated to another separate share or other shares of the estate or trust.

One private letter ruling suggests that if the entire trust property is decanted into another trust, the new trust is the same trust for income tax purposes as the one from which the payment was made. As a general matter, whether the Service considers the new trust to be the same as the old one when the entire trust corpus is decanted would seem academic. Even if the new trust is a different trust from the old one, all of the old trust’s DNI (which, under Treasury Regulation section 1.643(a)-3(e), would include capital gain because it would be the year of termination of the old trust) would shift to the new trust.

The trustee’s identity might be important if the undistributed taxable income of the old trust will be subject to a state or local income tax, but the new trust will not. The distribution from the old trust to the new trust would eliminate state or local income tax because no undistributed income would remain in the old trust. The opposite result could be effected as well—the old trust may not have been subject to state or local income tax, but the new one is, and the decanting may cause state or local income taxation that otherwise could have been avoided.

The argument that decanting does not change the trust is stronger when the trustees of the old trust create (or declare) the new trust rather than pay it to another trust that someone else has created. If the trustees pay the assets of the old trust to a trust that someone other than the trustees created, the new trust may not appear to be the same as the old one. Also, if someone other than the grantor or the trustees of the old trust creates the new trust, presumably the new trust will hold some property received from the new grantor—as a general matter, a trust is created only if it has a res (that

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68 See I.R.C. §§ 651, 662.
69 See id. § 663(a)(1).
70 See id. § 663(c).
71 See Priv. Ltr. Rul. 200736002 (Sept. 7, 2007). Under section 6110(k)(3), neither a private letter ruling nor a national office technical advice memorandum may be cited or used as precedent, although they may serve as precedent for purposes of avoiding certain tax penalties. See Treas. Reg. § 301.6684-1(b).
72 See, e.g., N.Y. TAX LAW § 605(b)(3)(D)(1) (McKinney Supp. 2012) (exempting from New York income tax the income of a trust created by a New Yorker if, among other conditions, the trust has no trustee who is a New Yorker).
is, property that someone contributed to it). In other words, the new trust likely would hold some asset that the grantor of the new trust contributed.

Whether state law treats a power to decant as similar to a special power of appointment should inform this analysis. Case law sometimes describes a trust created by the exercise of a power of appointment as being “read back into” the original trust. This generally means that the trustee must create the new trust within the scope of the authority that the original trust confers on the powerholder. Additionally, the rule against perpetuities begins to run from the date the original trust became irrevocable.

But when exercising the power of appointment to create a different disposition, as opposed to different governance (for example, changing the identity or authority of the trustees), the new trust seems to be created under the terms set forth in the powerholder’s instrument even if that instrument incorporates by reference terms of the original trust and is indeed a new trust. In that case, the tax analysis should follow from the property law treatment, and perhaps the tax treatment should be identical to the treatment a trust created by a nonfiduciary would receive if granted a lifetime power of appointment over the trust.

As indicated above, a distribution by the trustee, pursuant to a decanting statute, of less than the entire corpus of the trust seems to be the equivalent of a discretionary distribution by the trustee to a beneficiary. Presumably, this distribution will be deemed to consist of DNI, although special rules might limit the amount of DNI that is shifted from the trust to the beneficiary.

In any event, when property is paid to a new trust, such new trust must obtain a tax identification number (TIN), unless it is a grantor trust under

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74 To determine who is the grantor of a trust for tax purposes, the grantor who contributed property to the old trust remains the grantor of the new trust as to the property derived from the old trust as a result of the decanting. See Treas. Reg. § 1.671-2(e)(5) (“If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.”).

76 See Restatement (Second) of Conflict of Laws § 274 cmt. b (1971).

77 See Restatement (Third) of Prop.: Wills & Other Donative Transfers § 19.14 (2011) (“Unless the donor has manifested a contrary intent, a donee of a non-general power is permitted to make any appointment that benefits only objects of the power that the donee could make of owned property in favor of those objects.”).

78 See, e.g., N. Trust Co. v. Porter, 13 N.E. 2d 487 (Ill. 1938).

79 See, e.g., Treas. Reg. § 1.643(a)-3(c), exs. 8–9. Note that these two examples arise under the provision defining DNI and not under the provision dealing with separate shares.
sections 671 through 679, in which case it may be permitted to choose to use the grantor’s TIN.\textsuperscript{79} However, the trust to which the assets of the new trust are paid could be regarded as merely a continuation of the trust that made the payment, so the new trust could continue to use the TIN of the trust which made the payment.

1. **Negative Basis Assets**

When the property paid by the trustee pursuant to a decanting has a liability against it that exceeds the property’s income tax basis (that is, the property is a “negative basis” asset), whether gain will be recognized under *Crane v. Commissioner*\textsuperscript{80} is uncertain. Under the *Crane* doctrine, the amount realized, which is used to determine tax profit or loss,\textsuperscript{81} includes indebtedness discharged, including nonrecourse indebtedness.\textsuperscript{82} No developed legal standard exists for whether or when an estate or trust realizes gain by distributing a negative basis asset to a beneficiary.

Some have contended that section 643(e), which provides generally for the fiduciary’s basis in distributed property to carry over to the beneficiary, may override the *Crane* doctrine. This argument may not be persuasive, however, as the section by its own terms provides that the basis of the property distributed by the fiduciary to the beneficiary is “adjusted for any gain . . . recognized to the . . . trust [by] the distribution.”\textsuperscript{83}

Because it is possible that gain would be recognized by the trust on the distribution (by decanting or otherwise) by the trustee, such a distribution probably would be made only after careful consideration. The trustee might ask for a private ruling from the Service clarifying the issue, perhaps seeking to have the Service rule that the trust will recognize no gain if the entire trust is decanted because the new trust is the same trust as the old trust. Alternatively, the trustee could leave the negative basis asset in the old trust.

Nevertheless, the law seems well developed that, under sections 671 through 679, the conversion of a grantor trust to a nongrantor trust during the grantor’s lifetime is a gain recognition event to the extent liabilities for

\textsuperscript{80} 331 U.S. 1 (1947).
\textsuperscript{81} See id. at 5 (quoting I.R.C. § 111(a)).
\textsuperscript{82} See id. at 14.
\textsuperscript{83} I.R.C. § 643(e); see also Treas. Reg. § 1.661(a)-2(f).
an asset owned by the trust exceed its basis.\textsuperscript{84} Whether the same result would occur by reason of decanting is uncertain.

2. \textit{Beneficiary Gain}

Another question is whether the beneficiary realizes any gain by reason of decanting. Normally, under section 662(a), a beneficiary may experience income by reason of a trust distribution only to the extent of the trust’s DNI. However, the Service might contend that a change in the quality of the beneficiary’s interest in the trust could cause the beneficiary to experience income.

In \textit{Cottage Savings Ass’n v. Commissioner},\textsuperscript{85} the Supreme Court held that a company realized a loss when it exchanged certain mortgage note interests for other such notes that were materially different. The Service has indicated that it may view a beneficiary as experiencing gain under \textit{Cottage Savings} when, for example, the beneficiary’s income interest is “converted” into a unitrust interest unless the conversion is pursuant to a state statute or opinion of the highest court of the state.\textsuperscript{86} Also, Treasury Regulation section 1.643(b)-1 provides in part that a switch from an income interest to a unitrust interest, if “not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement), may constitute a recognition event to the trust or its beneficiaries for purposes of section 1001. . . .”\textsuperscript{87}

Nevertheless, if the governing instrument expressly authorized the trustee to change the beneficiary’s interest from an income interest to a unitrust interest, the beneficiary should experience no gain recognition because the beneficiary’s interest in the trust was always subject to that potential conversion. In Private Letter Ruling 200810019, the Service approved, without

\textsuperscript{84} See Madorin v. Comm’r, 84 T.C. 667, 678 (1985) (assuming that the power to add to the class of beneficiaries under section 674 conferred grantor trust status and that relinquishment of the power eliminated grantor trust status, triggering income tax realization).


\textsuperscript{86} See Priv. Ltr. Rul. 200013015 (Mar. 31, 2000) (ruling that the partition of the trust and changes in administrative provisions pursuant to New York’s decanting statute would not cause the beneficiaries, whose interests remained the same in the new trusts as in the old, to realize gain under \textit{Cottage Savings}). \textit{But see} Priv. Ltr. Rul. 200231011 (Aug. 2, 2002) (ruling that, under \textit{Cottage Savings}, a court-approved settlement, pursuant to which an annuitant received a unitrust interest instead of the annuity stream, constituted an income-taxable exchange); Priv. Ltr. Rul. 200736002 (Sept. 7, 2007) (ruling that a beneficiary might realize gain if the beneficiary’s interest in a successor trust, pursuant to a pro rata division of a trust, was materially different than in the original trust).

\textsuperscript{87} Treas. Reg. § 1.643(b)-1.
any adverse income, gift, or GST tax consequences, the conversion under state law of an income interest to a unitrust interest. For this purpose, state law permitting a unitrust conversion apparently need not have been in effect from the inception of the trust.

Treasury Regulation section 1.1001-1(h), which deals with the severance of a trust (including a severance that meets the requirements of Treasury Regulation section 26.2642-69 [the qualified severance regulation] or Treasury Regulation section 26.2654-1(b)90 [retroactive severances at death]), may also provide a partial answer. This regulation provides that a severance “is not an exchange of property for other property differing materially either in kind or extent if an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust and any non-pro rata funding . . . whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.”91

The Code, for this purpose, does not define the term severance. The term seems to imply, however, an action by the trustee authorized by the governing instrument or applicable state law and without judicial intervention or beneficiary consent. Accordingly, if the Service may treat a complete decanting to one trust as a continuation of the original trust, a decanting to create more than one trust perhaps might be treated as a severance that likewise has no gain realization consequences. Certainly, the qualified severance regulations treat certain divisions of a trust that produce new trusts with different beneficiaries as a severance.92 Moreover, Treasury Regulation section 1.1001-1(h) does not appear to require a qualified severance. Instead, the result seems to turn on the trustee’s ability to take the action under the terms of the governing instrument or under state law.

Therefore, the exercise by a trustee of a decanting power, whether conferred under the instrument itself or pursuant to state law, seems to result in no recognition of any gain or loss to a beneficiary. It seems critical to this conclusion is that the beneficiary’s consent, and possibly the court’s approval—which indirectly may require that the beneficiary consent or at least acquiesce—is not required for the trustee to distribute to the new trust, at

90 See id. § 26.2654-1(b).
91 Id. § 1.1001-1(h)(i)–(ii).
92 See, e.g., id. § 26.2642-6(j), ex. 2 (explaining that if the trustee of a discretionary trust for T’s children, A and B, and their descendants divides the trust pursuant to state law into two trusts, one for A and A’s descendants and one for B and B’s descendants, the severance constitutes a qualified severance).
least if beneficial interests are altered. This may raise a concern about what could be perceived as “stealth” modifications of trusts by ill-motivated trustees. These concerns caused the Florida drafting committee to include a notice—but not consent—requirement in the Florida statute and an express statement that beneficiaries retain all rights under the law, including a right to complain if the exercise of the decanting power is an abuse of discretion or otherwise a breach of trust. An abuse of discretion or breach of trust presumably would occur only if the decanting power is exercised beyond its scope.

3. Collateral Consequences

Decanting can also have collateral consequences. For example, the old trust might not be a grantor trust, but the new one is, or vice versa. Accordingly, it may be appropriate to note, as mentioned above, that conversion of a grantor trust to a nongrantor trust may cause the recognition of gain with respect to a negative basis asset. Nevertheless, the mere conversion of a nongrantor trust to a grantor trust would not appear to have tax consequences.

Similarly, the conversion of a domestic trust to a foreign trust may result in gain recognition under section 684, although if the grantor is living, section 684(b)’s grantor trust exception likely would apply. The result also likely would be the same if the assets of a U.S. trust were paid (by decanting or otherwise) to a foreign trust.

Another possible concern under the grantor trust rules arises under section 674. Some of the decanting statutes apparently do not prohibit advancing a remainder beneficiary into the class of current beneficiaries. The power to add to the class of beneficiaries is an exception to the exceptions under section 674 and, therefore, could cause the trust to be a grantor trust from its inception even if it were not otherwise one. Thus, if the decanting power permits adding beneficiaries, perhaps it also can cause grantor trust status for every trust that includes the power. This exception is articulated five times in section 674, including in section 674(c), which relates to the

97 See I.R.C. § 684(b).
99 See I.R.C. § 674.
use of independent trustees to avoid grantor trust status. Indeed, in Madorin v. Commissioner, it was eliminating the power to add to the class of beneficiaries that caused the trust to cease to be a grantor trust, thereby triggering the income tax realization event. 100

Accordingly, in a trust intended to be a nongrantor trust, one may wish, in an abundance of caution, to preclude the use of a decanting power in a manner that would permit the trustees to add to the class of beneficiaries within the meaning of section 674. Some statutes, such as New York's, avoid this issue by permitting decanting only in favor of "proper objects" of the exercise of the power to invade principal. 101 Furthermore, courts should construe the other statutes to contain a similar prohibition, or else they would be inconsistent with the concept that one is invading in further trust for the benefit of the beneficiaries for whom the power to invade exists.

Yet another question that arises is whether giving a beneficiary a lifetime power of appointment constitutes a power to add to the class of beneficiaries that implicates section 674. Under Florida law, neither a permissible appointee under a power of appointment nor the takers in default are necessary parties in a proceeding concerning the administration of a trust, and the powerholder can represent them virtually. 102 Accordingly, courts may more properly regard the permissible appointee as a person with a mere expectancy and not a beneficiary of the trust for any property law purpose that would implicate section 674.

Powers of appointment generally are regarded as personal powers that the powerholder may exercise without being held to any fiduciary standard. 103 This also might support the conclusion that the permissible appointees under a lifetime power of appointment are not beneficiaries of the trust and therefore also are not beneficiaries for any tax purpose. In that case, permissible appointees under a power of appointment could not be regarded as persons that may be added to the class of beneficiaries.

C. Gift Tax

At least two potential gift tax issues arise in the context of decanting:

1. Does a beneficiary who acquiesces to a decanting and thereby dilutes or forfeits a beneficial interest in the trust make a taxable gift?

100 See Madorin, 84 T.C. at 669, 677.
101 See N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2002).
102 See FLA. STAT. ANN. § 736.0302 (West 2010).
103 See RESTATEMENT (THIRD) OF TRUSTS § 75 (2003).
2. Does the power to decant itself, if held by a beneficiary acting as trustee, have gift tax consequences?

A person makes a gift for federal tax purposes to the extent she transfers property worth more than what she receives, in money or money’s worth, in exchange. 104 A beneficiary who did not create the trust and who also does not hold a presently exercisable general power of appointment described in section 2514(b) should not be treated as making a gift if the trustee, other than the beneficiary, invades by placing the property in further trust pursuant to a decanting power. 105 A trustee who has a beneficial interest in the trust could be regarded as making a gift if that trustee participates in exercising a decanting power.

In fact, Treasury Regulation section 1.643(b)-1 provides, in part, that a switch from an income interest to a unitrust interest, if “not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement)[,] may . . . result in taxable gifts from the trust’s grantor and beneficiaries, based on the relevant facts and circumstances.” 106 If the relevant facts and circumstances were not to include whether the beneficiary had a right to prevent the switch, the contention would apparently conflict with the well-established law that a person may make a taxable gift only by making a voluntary transfer. 107

The gift tax is imposed on the donor’s act of transfer of an interest in property. 108 Treasury Regulation section 25.2511-2(a) provides the following:

The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, . . . is measured by the value of the property passing from the

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104 See I.R.C. § 2512.
105 See Treas. Reg § 25.2511-1(g)(2).
106 Id. § 1.643(b)-1.
108 See Estate of DiMarco, 87 T.C. at 657–58.
donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.\textsuperscript{109}

The regulation requires an act of transfer.\textsuperscript{110} If the act of transfer is not voluntary, then no taxable gift occurs. Thus, only if the beneficiary has a legal right to object to the exercise of the authority to decant might the trustee’s exercise of a decanting power cause a beneficiary to make a taxable gift.\textsuperscript{111}

The prospects of objecting to the exercise of discretionary authority by a fiduciary under state law are generally quite narrow. Section 50 of Restatement (Third) of Trusts provides as follows:

(1) A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee.

(2) The benefits to which a beneficiary of a discretionary interest is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor’s purposes in granting the discretionary power and in creating the trust.\textsuperscript{112}

As indicated, a court generally interposes on the exercise of a trustee’s discretion only in the case of an abuse of discretion.\textsuperscript{113} Accordingly, if a trustee exercises a decanting power consistent with state law, a beneficiary should be unable successfully to oppose the exercise of the trustee’s discretion.

\textsuperscript{109} Treas. Reg. § 25.2511-2(a).

\textsuperscript{110} See id. § 25.2511-1(a).

\textsuperscript{111} Revenue Ruling 81-264 confirms that a taxable gift can occur by permitting legal rights to expire. See Rev. Rul. 81-264, 1981-2 C.B. 185. General Counsel Memorandum 38,584, relating to Revenue Ruling 81-264, acknowledges, however, that under certain circumstances the taxpayer may be able to show that the statute of limitations lapsed “in the ordinary course of business” based upon the prospects of succeeding in litigation. See Gen. Couns. Mem. 38,584 (Dec. 10, 1980) (quoting Treas. Reg. § 25.2512-8).

\textsuperscript{112} RESTATEMENT (THIRD) OF TRUSTS § 50 (2003).

In addition, the GST regulations indicate that implied consent or acquiescence to changes effected by judicial proceedings or nonjudicial settlement can have tax consequences different from the exercise of fiduciary powers, at least when the fiduciaries are not independent.\textsuperscript{114} Hence, if the beneficiary were the trustee (or, perhaps, one of the trustees) who decanted and in the process gave up property interests, the GST regulations could charge the beneficiary with making a gift by decanting because the exercise of authority would be a voluntary act, although taken in a fiduciary capacity.\textsuperscript{115} Moreover, if decanting is akin to a power of appointment, a beneficiary-trustee may have tax consequences even if the beneficiary's interests in the trust are discretionary.\textsuperscript{116}

Statutes that require the trustee to have absolute discretion to invade principal do not appear to create additional tax difficulties for the beneficiary acting as a trustee over and above those already present as a result of the absolute distribution authority.\textsuperscript{117} A trustee who is a beneficiary of the trust would be treated as holding a general power of appointment within the meaning of sections 2514 and 2041 if the trustee had absolute discretion to distribute principal to herself.

In addition, the Service might treat a trustee who is also a beneficiary and who is not permitted to make distributions to herself, but is permitted to make distributions to other beneficiaries, as making a taxable gift on the exercise of that authority.\textsuperscript{118} Accordingly, a trustee who is also a beneficiary typically would receive tax protection either by a restriction in the governing instrument or by means of a state statute\textsuperscript{119} restricting distributions by a


\textsuperscript{116} See Priv. Ltr. Rul. 200243026 (Oct. 25, 2002) (ruling that exercise of a lifetime special power by a spouse who was also a discretionary beneficiary was a taxable gift and direct skip) (citing Rev. Rul. 75-550, 1975-2 C.B. 357 for a possible method of computing the taxable gift and concluding that the value of the spouse’s income interest in a trust for purposes of section 2013 was computed “by taking into account the estimated amount of all possible invasions from the corpus on a year-to-year basis”).

\textsuperscript{117} See, e.g., FLA. STAT. ANN. § 736.04115(2)(a) (West 2010).


\textsuperscript{119} See, e.g., N.Y. EST. POWERS & TRUSTS LAW § 10-10.1 (McKinney 2002); FLA. STAT. ANN. § 736.0814(2); REV. PROC. 94-44, 1994-2 C.B. 683 (holding that the enactment of a Florida statute curtailing the powers of a beneficiary-trustee to make distributions to himself to an ascertainable standard would not be treated as causing a lapse of a power of appointment for purposes of sections 2041(b)(2) and 2514(e)).
beneficiary who is also a trustee to an ascertainable standard of health, education, maintenance, and support within the meaning of section 2041(b)(2). In either case, the trustee-beneficiary would not, as a result of the application of the standard, have the authority to decant under a state statute requiring absolute discretion to do so. States that permit a trustee without absolute discretion to decant generally require the trustee to respect and preserve the standard of invasion in the decanted trust, thereby avoiding gift tax risk to a beneficiary-trustee with authority to decant.\textsuperscript{120}

Granting a special power of appointment to a beneficiary of a decanted trust may be appropriate to ensure that any gift the beneficiary is charged with making would be incomplete for gift tax purposes. An incomplete gift is not subject to gift tax.\textsuperscript{121}

D. Estate Tax

If decanting resulted in a beneficiary’s making a gift for federal gift tax purposes, her gross estate might have to include the decanted trust property if the beneficiary’s transfer fell under section 2035, 2036, 2037, 2038, 2039, or 2042. If decanting otherwise would cause the beneficiary to be treated as making a gift for federal gift tax purposes and the beneficiary had a special power of appointment to prevent any such gift from being complete, the decanted property likely would be included in her gross estate under either section 2036(a)(2) or 2038.

Revenue Ruling 95-58 implies that if the settlor may remove the trustee and name another as trustee, the trustee’s powers under section 2036 or 2038 are attributed to the trust’s settlor (causing estate tax inclusion in the settlor’s estate), unless the settlor may not appoint herself or anyone who is related or subordinate to the settlor as trustee within the meaning of section 672(c).\textsuperscript{122} Unofficially, the Service has extended the possibility of attribution of the trustee’s powers to beneficiaries acting as trustees, potentially causing them to hold a general power of appointment.\textsuperscript{123}

If a nonadverse trustee can participate in a decanting, does that raise tax concerns for a beneficiary? If the trustee must acquit her fiduciary duties appropriately and is not, because of a removal and replacement power, a puppet of the beneficiary, then the trustee’s ability to decant, by itself, should not raise tax concerns. Instead, the permissible provisions of the de-

\textsuperscript{120} \textit{See, e.g.}, \textsc{Alaska Stat.} § 13.36.157 (2008).
\textsuperscript{121} \textit{Cf. Treas. Reg.} § 25.2511-2(c).
\textsuperscript{122} \textit{See Rev. Rul.} 95-58, 1995-2 CB 191.
\textsuperscript{123} \textit{See Priv. Ltr. Rul.} 200551020 (Sept. 21, 2005).
canted trust will determine whether the beneficiary’s authority to participate in the decision to decant raises tax concerns for the beneficiary. For example, if the power to decant confers authority on the beneficiary that would enable the beneficiary to participate in making distributions not limited by an ascertainable standard within the meaning of section 2041, then the decanted trust itself would raise concerns if the beneficiary had authority to participate in the decision to decant.

Many states have enacted legislation that would prohibit a beneficiary-trustee from participating in a power to decant.\textsuperscript{124} The statement in the decanting statutes that the power to decant must be construed as a nongeneral power of appointment\textsuperscript{125} should be enough to prohibit a beneficiary-trustee from participating in a decanting that would give the beneficiary-trustee an interest in the trust tantamount to a general power of appointment. Moreover, any view that a removal and replacement power vitiates a trustee’s fiduciary duties would appear incorrect because it ignores the fiduciary duties of a trustee who, even if related and subordinate, has liability to the beneficiaries for failure to fulfill the duty of impartiality by preferring the interests of a beneficiary-trustee.

Some statutes contain an exception to the prohibition on a beneficiary-trustee’s participation in the power to decant if an ascertainable standard limits the distributions.\textsuperscript{126} The intent of the exception is to reflect the fact that if an ascertainable standard limits a beneficiary-trustee’s authority with respect to distributions or a power of appointment, the power is not a general power of appointment under section 2041. The Delaware decanting statute states that if the trust contains a standard, the exercise of the power to decant must be in furtherance of the standard.\textsuperscript{127} Other statutes simply permit a beneficiary-trustee to participate in the decanting only if a standard limits distributions.\textsuperscript{128} The question is, to the extent that a beneficiary-trustee can participate in the decanting, whether the new trust to which property is decanted also must contain the standard. The answer appears to be in the affirmative because any contrary construction would seem to be an exercise of distribution authority by the beneficiary-trustee beyond the scope of the beneficiary-trustee’s authority in the original trust.

\textsuperscript{124} See, e.g., FLA. STAT. ANN. § 736.0814(2) (West 2010).
\textsuperscript{125} See id. at § 736.0814(4).
\textsuperscript{126} See id.
\textsuperscript{128} See, e.g., FLA. STAT. ANN. § 736.0814(4).
E. GST Tax

As mentioned above, the final GST tax regulations provide that if the trustee decants other than by a state law in effect when the trust became irrevocable or by a power contained in the governing instrument, she will forfeit any grandfathering from tax.

As to a grandfathered trust, it seems that the trust’s duration may not be extended beyond the GST rule against perpetuities. If the trust is not grandfathered, but rather exempt by reason of an allocation of GST exemption, the Service appears to agree that, at a minimum, a change to a trust that would not affect the GST-exempt status of a grandfathered trust likewise should not affect the GST-exempt status of a trust exempt by reason of an allocation of GST exemption. More comprehensively, any decanting that would not create a new transferor would appear not to dissipate any effect of a prior allocation of GST exemption. Thus, exercising the authority to decant the trust to extend its duration beyond the GST rule against perpetuities would not appear to have an adverse effect on a trust exempt by reason of an allocation of GST exemption. At a minimum, no such adverse effect should occur if the authority to so decant the trust existed at the time the trust became irrevocable, whether as a result of a power in the governing instrument or applicable state law.

The Treasury Regulations deal with discretionary powers (which should include decanting) differently from a modification. Treasury Regulation section 26.2601-1(b)(4)(i)(A) states that a “distribution of trust principal from an exempt trust to a new trust . . . will not cause” loss of exempt status if the terms of the governing instrument or applicable state law at the time the trust became irrevocable authorize the distribution to the new trust without the consent or approval of any beneficiary or court, and “[t]he terms of the governing instrument of the new . . . trust do not extend the time for vesting . . . in a manner that may postpone . . . the vesting . . . beyond any life in being at the date the original trust became irrevocable plus a period of 21 years . . . .”

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129 See Treas. Reg. § 26.2601-1(b)(4)(i)(A)(2); see, e.g., Priv. Ltr. Rul. 201218002 (Dec. 29, 2011) (permitting the beneficiary of a grandfathered trust to exercise a testamentary special power of appointment in further trust and to add, as measuring lives for duration of those trusts, descendants of the beneficiary’s great-grandparents living on the date the original trust became irrevocable).
131 See I.R.C. §§ 2631(a), 2652(a)(1).
If the terms of the governing instrument do not postpone the vesting of interests, then other changes that do not shift beneficial interests to lower generations will not cause loss of exempt status, even if done pursuant to a decanting statute enacted after the trust became irrevocable. Furthermore, if the vesting of the interest is not postponed but the decanting, pursuant to statute, shifts interests to lower generations, exempt status should not be lost even if the decanting statute was enacted after the trust was created. Nonetheless, the Service has expressed some concerns about this result during the process involving certain requests for private letter rulings.

1. Further Grandfathering Issues

A trustee’s exercise of a state-conferred decanting power that extends the term of the trust created before the effective date of the GST tax could cause the loss of the trust’s grandfathering. The Treasury Regulations indicate that the distribution of trust principal in a grandfathered trust to a new or continuing trust will not cause the property to lose its exemption from taxation if either (1) the terms of the exempt trust instrument authorize such distribution, or (2) state law in effect when the trust became irrevocable authorized the distribution without the consent of a court or any beneficiary.

None of the decanting statutes were in effect when the GST tax took effect. Thus, the requirement that state law authorized the distribution when the trust became effective would not be met based on these state statutes for trusts that are exempt by reason of the grandfathering rule.

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133 See Priv. Ltr. Rul. 9737024 (Jun. 17, 1997) (stating that no loss of grandfathering occurs if the quality, value, or timing of any beneficiary’s interest or power does not change pursuant to decanting under the New York decanting statute); Priv. Ltr. Rul. 9804046 (Oct. 28, 1997) (stating that no loss of grandfathering occurs when decanting under New York’s decanting statute changed spendthrift provision); Priv. Ltr. Rul. 200227020 (Apr. 1, 2002) (stating that no loss of grandfathering occurs when situs of trust changed from New York pursuant to decanting under the New York decanting statute because the trust would end at the same time); Priv. Ltr. Rul. 9438023 (Jun. 27, 1994).


136 See id. § 26.2601-1(b)(3) (noting that certain trusts created after the initial effective date of the GST tax are exempted (e.g., where the settlor was incompetent)). It may be that one of the state decanting statutes might have been enacted for these special-date grandfathered trusts by the time this kind of trust became irrevocable).
At least three issues exist regarding whether the trustee may exercise the power to invade in trust without negative GST tax effects. The first issue is whether the applicable state’s common law permitted decanting. As discussed above, a decanting power was apparently present under the common law of Florida,\(^{137}\) and one might argue that the power existed under the common law of every state.

Second, the Service has not construed the regulations strictly. For example, the Service has allowed trustees, under the New York decanting statute, to exercise the power with respect to a grandfathered trust to make the trust spendthrift and to change the trust’s situs.\(^{138}\) It may well be that as long as the trustee does not extend the term of the trust or shift beneficial interests to a lower generation, no loss of grandfathering occurs. This arguably means that the trustee could grant a beneficiary a special power of appointment, which, subject to Treasury Regulation section 26.2601-1(b)(1)(v)(B)(2), could be exercised without the loss of grandfathering.

Third, the trustee can exercise the power for the shorter of (1) a period equal to the lives in being at the time the trust became irrevocable plus twenty-one years or (2) the maximum period so that the trust would not lose grandfathering protection.\(^{139}\) The challenge in this approach is that the trustee will not know when the trust in fact terminates and thus when payments of GST tax are due.

2. **Nongrandfathered but GST Exempt in Whole or Part**

A generation-skipping trust may be exempt, in whole or in part, from GST tax not only by reason of grandfathering but also by reason of allocation of GST exemption to transfers to the trust.\(^{140}\) Although the Service in private letter rulings has applied certain grandfathering rules to trusts that are exempt by reason of allocations of GST exemption,\(^{141}\) whether the exer-

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\(^{139}\) See Priv. Ltr. Rul. 200227020 (Apr. 1, 2002) (ruling that grandfathering would not be lost in decanting a trust and explicitly noting that the new trust “will provide that, notwithstanding any other provision, no exercise of a power of appointment granted in the trust shall result in a termination date for a trust or a share thereunder or created pursuant to a power of appointment granted thereunder which is later than the date twenty-one years after the death of the survivor of all of Sister’s descendants living at Decedent’s death”).

\(^{140}\) See I.R.C. § 2631(a).

cise of a state decanting power would cause the trust to lose its exemption from taxation is uncertain.\textsuperscript{142}

Many new trusts likely were irrevocable at the time the applicable state enacted its decanting statute. This is true in Alaska, Delaware, New York, and Tennessee.\textsuperscript{143} Therefore, applying the literal grandfathering requirements to a GST-exemption allocated trust would not cause the trust to lose its exemption from taxation.

Furthermore, the policy considerations for trusts that are exempt from tax by reason of allocation of GST exemption are quite different from those for trusts exempt from tax by reason of their effective date. If the authority to decant existed, either in the governing instrument or under state law where statutory decanting was in effect when the trust became irrevocable, it would be difficult to contend that a trust that is exempt from tax by reason of an allocation of GST tax exemption loses its exemption when the trustee exercises a decanting power, even if the term of the trust is extended or beneficial interests are shifted.

Neither the Treasury Regulations nor other authority cover the effects of decanting on a trust that is neither grandfathered from GST tax nor subject in its entirety to the tax by reason of allocation of GST exemption. Many of the revenue rulings that address trusts exempt by reason of an allocation of GST exemption include the following language:

No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, should similarly not affect the exempt status of such a trust.\textsuperscript{144}

Because a trust that is exempt in whole or in part by reason of allocation of GST exemption could postpone vesting for any period permitted under applicable law, decanting to attain that result should not cause the loss of that exemption. Moreover, at least in some states (for example, New York),

\textsuperscript{142} See Priv. Ltr. Rul. 9849005 (Dec. 4, 1998) (holding that GST exemption allocation to a trust that made it exempt from the tax would continue if the trust were to use the New York decanting statute to pay the corpus over to a successor trust with identical terms).


\textsuperscript{144} Priv. Ltr. Rul. 200839025 (Sept. 26, 2008).
the decanting statutes have existed long enough that they may well have been in effect at the trust’s creation. Thus, using the decanting power should not result in loss of exemption effected through the allocation of GST exemption.

The decanting of a trust pursuant to applicable state law also might be construed as a severance that fails to meet the requirements of a qualified severance. In that event, even though the severance is not qualified, after the date of severance GST tax regulations will treat the trusts as separate, provided that state law recognizes the post-severance trusts as separate trusts.

Assuming the trusts are treated as separate trusts, GST tax exemption may be effectively allocated to only one or more of the trusts without being treated as having been allocated ratably to all the trusts. This would permit a trust to be divided to allow a late allocation of GST exemption to only part of the trust estate, with the result that one or more trusts will have an inclusion ratio of zero and one or more trusts will have an inclusion ratio of one.

In addition, if the severance results in a taxable termination or a taxable distribution as to a portion of the trust (for example, because one of the trusts is a skip person), the taxable event occurs only with regard to that particular resulting trust, with no GST tax impact on any other trust resulting from the severance. Each trust resulting from such a severance (prior to the allocation of any additional GST exemption) will have the same inclusion ratio as the original trust. Changes to the governance of the trust permitted under state law or by judicial reformation should be respected, particularly if these occur prior to the time GST exemption is allocated to the trust.

VII. CONCLUSION

The common law of every state likely confers decanting authority on trustees. The number of states with express legislation and the number of trust agreements that include an express decanting power are growing. The decanting authority, when exercised consistent with the fiduciary duties imposed on trustees by state law and applicable limitations on the ability of a

\[145\] See Treas. Reg. § 26.2642-6(h).
\[146\] See id.
\[147\] See id.
\[148\] See id.
\[149\] See id.
trustee to make distributions in the trustee’s own favor, ought not, by itself, to have tax consequences either to the trustee or to any beneficiary. To the extent the power is exercised, the tax consequences of that exercise will depend upon the terms of the recipient trust and the rights under state law of any person to avoid the exercise of the decanting power.