As advisors have more in-depth discussions with clients about their estate planning goals and intentions, it becomes clear that a certain amount of flexibility, or adaptability, is a critical feature of any truly workable long-term plan. At Northern Trust, we know that many of our clients – whether as grantors, beneficiaries or trustees of irrevocable trusts – often come to understand what sort of flexibility is most important to them in the context of existing trusts that are no longer fulfilling their intended purpose. In these cases, the initial tax objective was often readily achieved. Over time, however, meaningful shortcomings in the larger plan may be revealed: trust principal is too readily available to a beneficiary suffering from addiction, a lack of special needs provisions jeopardizes a beneficiary’s qualification for governmental benefits, restrictions on investments make it difficult to achieve the growth rate needed to sustain the trust, and so on.

In conversations that are less about minimizing taxes and more about achieving comprehensive wealth transfer goals, sharing these sorts of scenarios with clients may help them better articulate their own intentions and concerns. This is valuable information to the advisor engaged in prospective planning, tasked with drafting documents that meet clients’ changing needs. The insights gained, however, may also bring to light opportunities to improve the functionality of those parts of the estate plan already in place.
When available, decanting can be a powerful tool to help us take what we learn from our clients in the context of these new conversations and not only address deficiencies in an existing plan, but also craft a new one.

WHAT IS DECANTING?
In the world of estate planning, “decanting” refers to an exercise of the trustee’s discretion to distribute principal to one or more beneficiaries, by distributing the original trust to a new trust for the benefit of the same person(s). The decanting metaphor is apt. The decanting of wine, for example, leaves behind the sediment that naturally forms over time, or impurities that were not filtered out during the winemaking process. The decanted wine is a clarified version of the same liquid, only in a new vessel. Trust decanting should achieve a similar result: a new trust whose provisions are better able to fulfill the grantor’s original intention, without changing it.

Trust decanting has its basis in common law. If a trustee has absolute discretion to make a distribution to a beneficiary outright, goes the rationale, certainly he can make the same distribution with restrictions, including to a trust for the benefit of the same beneficiary, unless the governing instrument provides otherwise. In many ways this distributive power is akin to a special power of appointment, limited only (but crucially) by being held in a fiduciary capacity.

Is it wise to rely on a common law power to decant? Of all the states, only Florida has precedent from the state’s highest court holding that there is such a power at common law. While this suggests decanting may be part of the common law of other jurisdictions, there is no certainty where there is no precedent. From a fiduciary perspective, it is difficult to reconcile the exercise of such a power with the magnitude of legal uncertainty such an exercise might entail.

At Northern Trust, we believe a trustee should consider decanting only where such a fiduciary power is expressly authorized by the trust agreement or by state statute, in a manner that clearly defines the scope of the power and the conditions under which it can (or cannot) be exercised.

While decanting is not on the books in all jurisdictions, each year it becomes more widely available. Currently, 16 states have decanting statutes, and legislation has been introduced in a number of others. The IRS has issued several private letter rulings over the years regarding the transfer and income tax consequences of decanting, and recently added these issues to its priority guidance plan. In April 2012, the IRS closed a public comment period in anticipation of drafting such guidance.

With increasing frequency, we also see a decanting power specifically granted to the trustee in irrevocable trust agreements. Such provisions may compensate for a lack of an enabling state statute or simply ensure the power is tailored by the grantor, who may not wish to leave such details to the legislature.

A WELL-DRAFTED STATUTE OR DECANTING PROVISION WILL, IDEALLY, ANSWER THE FOLLOWING QUESTIONS:
- Must the trustee have absolute discretion to distribute principal?
- If there is a discretionary standard in the original trust, must that standard be retained in the decanted trust?
- Under what circumstances, if any, can the interest of a current beneficiary be eliminated by decanting, or the interest of a remainder beneficiary be accelerated?
- Is there a standard of care for purposes of reviewing the trustee’s exercise of the decanting power?
- May the term of the decanted trust be longer than the term of the original trust?
- Is the structuring of the decanted trust affected by provisions meant to safeguard the tax status of the original trust, such as where the original trust qualified for a marital deduction or is grandfathered from generation-skipping transfer tax?
- What constitutes evidence of the grantor’s intent, or a contrary intent?
Together, these developments illustrate a general acceptance of decanting as a user-friendly tool to modify an irrevocable trust. This should not be surprising. The popularity of long-term trusts along with frequently changing tax laws make it plain that most irrevocable trusts will need some sort of modification during their course if they are to continue to serve their original purpose. Traditional, judicial means of modification, such as reformation or construction, and nonjudicial means, such as settlement agreements and virtual representation agreements, are expensive, time consuming and frequently inadequate. Decanting, however, provides the legal means to make those modifications more economically and efficiently, in response to a growing demand for such flexibility.

WHY DECANT?

Every estate planner has encountered a situation where a client has created one or more irrevocable trusts that no longer meet the client’s objectives. The less flexible the trust, the more likely this is to occur.

There are various reasons a trust may become dysfunctional. Certainly, changes in family circumstances can render an existing plan unsuitable. For example, a trust that provides for outright distributions may come to represent more harm than good for a beneficiary who develops substance abuse or creditor problems, or simply is not mature, knowledgeable or responsible enough to manage her own finances. By contrast, a beneficiary who is particularly skilled in financial management misses an opportunity if the trust that constitutes most of her wealth does not allow her to participate in investment decisions.

The mere passage of time can also inflict its own damage. Often administrative provisions become stale as investment approaches and tax laws change, impeding efficient administration. As investment alternatives emerge over time, trust provisions may limit opportunities to take advantage of them, or even prohibit them altogether. Tax laws are ever changing, and once-favorable trust provisions may no longer confer any tax advantage, or even result in negative tax consequences. We know, too, from recent events, that a change in the tax laws can wreak havoc on entire dispositive schemes when the language used in drafting relies on a certain tax landscape to remain solid ground.

Decanting may be used to address any of these issues, provided the trustee has the authority under governing law and the trustee’s exercise of discretion to decant is consistent with the trustee’s fiduciary duties. With more than a century’s experience in trust administration, we at Northern Trust have found that the most common reasons for any trust modification, including decanting, are not tax related. Instead, they are directly related to the ability of the trust to protect and provide for the welfare of its beneficiaries, and to support and encourage the personal values of the grantor. The following are among the most common types of modifications made through decanting to these ends:

- Restricting distributions or delaying vesting of interests
- Accelerating or enlarging beneficial interests
- Enabling beneficiaries to participate directly in certain decision-making for the trust, e.g., as co-trustee or investment advisor
- Providing greater flexibility with regard to investments
- Segregating fiduciary powers, such as distributions and investments
- Dividing trusts for beneficiaries with divergent needs and/or interests
- Consolidating trusts similar in purpose and beneficial interests
- Clarifying the status and beneficial interests of same-sex partners
- Adding supplemental needs and spendthrift provisions

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Our experience leads us to believe that the changing conversations between estate planners and their clients are likely to highlight many opportunities to improve on an existing plan, as individual values and goals are better articulated. In many cases, decanting will be an ideal tool to make these improvements. If decanting is not available for an existing irrevocable trust, or if an irrevocable trust is a new component of the estate plan, the potential benefits of decanting might be reason enough to include a decanting power when drafting new trusts or selecting their situs, to ensure flexibility for the client going forward.

FAILING TO WORK VS. FAILING TO PLEASE
There is, of course, a difference between a trust that is not fulfilling its purpose, and one that is doing exactly what it was intended to do, but displeases a client. It is particularly important in advising the client or approaching the trustee to remember that any decanting must be consistent with the grantor’s intent and the trustee’s fiduciary duties. It is also critical from a planning perspective to ensure that any decanted trust retains provisions that may have enabled the original trust to qualify for a particular tax benefit, such as a marital deduction or annual gift tax exclusion, or that still represent a current tax advantage, such as grandfathering from the generation-skipping transfer tax, or exclusion from the gross estate of a beneficiary.

For the trustee, inefficiencies in administering the trust or difficulty navigating beneficial interests may bring the need for modification – and the opportunity for decanting – to light. Yet often it is the grantor or beneficiary who comes to his advisor, or the trustee, with a concern that the trust is no longer “working” as intended. These concerns may be quite legitimate. In particular, performance of investments, changes in family circumstances or a divergence of interests of beneficiaries can dramatically affect whether the trust provisions are adequate to achieve their original purpose.

Unsurprisingly, however, what is couched as a concern may merely be dissatisfaction with the actual, intended purpose of the trust. A grantor may become estranged from his child and regret having created a support trust for the child’s sole benefit. A beneficiary may prefer the lifestyle he could live with unlimited funds to the more modest lifestyle the grantor thought would help the beneficiary develop a work ethic similar to his own. Decanting is not a “fix” for such problems, since nothing is truly broken.

OVERLAPPING CONVERSATIONS
Grantors may desire flexibility but still have concerns that any tool that makes a trust more flexible might also be used to manipulate the terms of a trust in a manner, or to ends, contrary to the grantor’s original intent. In response to those concerns, the fact that a decanting power is a fiduciary power should bring some peace of mind for clients. Importantly for advisors, it also means that the parameters of the power will be defined, in part, by the clarity of language that articulates any standard for principal distributions or otherwise expresses the grantor’s intent. In that respect, topics that have appeared already in this series – on the use of precatory language and statements of intent, as well as on the drafting of discretionary standards – are both relevant to and informed by decanting.
By changing the conversation, tax planning is recast as just one element of building a legacy. Decanting may present an opportunity for the advisor to employ the insights obtained from these conversations to maximum advantage for clients, and perhaps even to have these conversations with a broader client base. For some clients, decanting may be only a tool to incorporate in current documents, to enhance adaptability in the future. For others, it may be currently available as a means to adapt existing irrevocable trusts to circumstances that have already changed to the detriment of the trusts’ original purpose. In all cases, Northern Trust is pleased to offer our clients and their advisors our unique fiduciary perspective on the use of decanting, as well as the depth and breadth of our experience in its practical application.

“Changing Conversations” is a series of articles authored by Northern Trust thought leaders from across the country intended to present unique perspectives on the new trends and approaches to wealth transfer planning resulting from the myriad of recent tax law changes. Our goal remains to provide fellow advisors with our best insights on topics – some familiar, some not – and to foster and enrich new conversations with clients as we work together to chart a course through often unfamiliar waters. Please contact us to continue the discussion offered in any of these pieces or to provide your feedback.

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