Can't trust a trust? Decant!

By Dan W. Holbrook

Effective July 1, Tennessee adopted its own version of the Uniform Trust Code (UTC) in Public Chapter 537. Seminars across the state this summer will no doubt explore its many provisions in detail, including some welcome ways to modify, reform, or terminate trusts, or to effect nonjudicial settlements.

One special provision added by the Tennessee UTC Study Committee, not part of the model UTC, deserves honorable mention: Section 74(b)(27)[1], probably to be numbered TCA §35-__-815(b)(27), commonly known as the "*decanting power*." Rather innocuously, the Official Comments to the Tennessee UTC describe the power as follows: "Paragraph (27) authorizes a trustee who possesses a discretionary power to distribute principal outright to trust beneficiaries to exercise that power in further trust." Bottom line, in the right circumstances: if you don't like the current trust, pay the trust assets over to a different trust!

Trust instruments frequently give the trustee a power to distribute principal "*to or for the benefit of*" a beneficiary. What exactly does "for the benefit of" mean? Common understanding would include direct payments for tuition, health care, support and the like. For minors, "benefit" would no doubt include payments to a legal guardian for support. For adult beneficiaries, "benefit" implies that the beneficiary has become incapacitated, or at least untrustworthy, requiring the trustee to make payments to third parties for reimbursement of expenses on behalf of the beneficiary.

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Can "benefit" be interpreted to include exercising the power in favor of a completely different trust? A cursory search of Tennessee cases reveals no such prior instance, but that does not mean the idea is farfetched. It is at least arguable that under the common law a power of appointment "to or for the benefit of" a beneficiary may be exercised by appointing in further trust for that beneficiary. Under the Restatement of Property 2nd, Donative Transfers, §11.1 (comment d.), a trustee's power to make discretionary distributions is a power of appointment. Thus a power to decant may exist without need of statute.

However, the new decanting power in Tennessee's UTC brings greater certainty and protection to the trustee, who might otherwise fear liability for so acting. Moreover, the statute creates a specific method, and specific parameters, for such exercise of the power, *without court order and without consent of beneficiaries*.

Is this a good thing? That remains to be seen. Are there limits? Certainly, and some are spelled out in the statute: you can't change the "proper objects" of the trust, reduce a fixed income interest, or violate the rule against perpetuities. In any event, fiduciary powers must be exercised in good faith in accordance with the terms and purposes of the trust and the interests of the beneficiaries (UTC Sections 60 and 72) and not for the benefit of the trustee (UTC Section 61). Moreover, estate, gift and generation-skipping tax consequences should always be considered. Beyond that, who knows? The outer limits of the decanting power are yet to be defined, and may be quite expansive indeed. Paragraph (27) may be the "sleeper" provision in the UTC that allows wholesale reformation of trusts in unexpected ways, for much good or much mischief, depending on the perspective.

Examples [Assume in each case the trustee can freely invade principal to

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or for the benefit of the beneficiary]:

(1) Spendthrift. Beneficiary B, age 24, is a spendthrift and is supposed to receive a distribution of all principal at age 25. Instead, Trustee T (or perhaps the original trustor) creates a new trust now, and T decants old trust to the new trust, which doesn't pay to B until age 35. Moreover, new trust contains a spendthrift provision lacking in old trust.

(2) Disability. Beneficiary B becomes totally disabled and is supposed to receive a distribution of principal next year. That would necessitate a court-appointed conservator and preclude B's eligibility for SSI and medicaid benefits. Instead, Trustee T creates a "special needs trust" and distributes B's share of old trust to the new trust, which continues to hold the trust assets for B's entire life.

(3) Wicked Stepmother. Dad dies, leaving Stepmom as trustee of trust during her own life, remainder *outright* to Dad's only child, Daughter, if then living, otherwise to Stepmom's children. The trust gives the trustee the power to invade principal to or for the benefit of Daughter, but not to or for the benefit of Stepmom herself. Stepmom creates new trust, changes the remainder to Daughter to continue in trust *for life*, remainder to Stepmom's children, and decants the trust assets from the old trust to the new trust. Is this change of Daughter's interest from outright to life interest a violation of the "good faith" requirement? Does it matter whether Daughter has any children of her own? What if Daughter really is a spendthrift?

(4) Successor Trustee. T wants to resign as trustee, but the trust instrument names X as successor trustee, and T does not want X to serve. T exercises the decanting power to pay the trust over to an identical trust except Y is trustee instead of X. Does the trustor's intention matter? What if it is the original trustor who no longer wants X to serve?

(5) Special Provisions. Corporate trustees often have specific provisions they want included in a trust on which they are to serve as trustee. Trustee T is willing to resign and let Bank B serve as successor Trustee. T prepares a new trust instrument naming Bank B as trustee and adding Bank B's special language, and then exercises the decanting power to pay the old trust to the new trust.

(6) Taxes. Trust instrument gives Beneficiary B a general testamentary power of appointment over the trust, which will cause the entire trust to be included in B's taxable estate at her death. Trustee T creates a new trust without such a general power of appointment, and decants old trust to the new trust. B dies without having to include the trust in her taxable estate.[2]

New York has had a decanting statute since 1991, and Alaska (1998) and Delaware (2003) have enacted substantially identical decanting powers.[3] Trust attorneys in those states say the power has been widely used. Attorneys in other states have even moved a trust situs temporarily into one of those three states long enough to apply the decanting statute before moving the trust back out again. Time will tell whether Tennessee and these other states find the decanting power a major boon or a dangerous weapon, but for now it is an experiment with great promise.[4]

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1. The decanting statute reads as follows:
(27) Unless the terms of the instrument expressly provide otherwise:
(A) A trustee who has authority, under the terms of a testamentary instrument or irrevocable inter vivos trust agreement, to invade the principal of a trust to make distributions to, or for the benefit of, one or more proper objects of the exercise of the power, may instead exercise such authority by appointing all or part of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created or under the same instrument, provided, however, that the exercise of such authority:
(1) does not reduce any fixed income interest of any income beneficiary of the trust; and
(2) is in favor of the proper objects of the exercise of the power.
(B) The exercise of the power to invade the principal of the trust under subsection (A) of this section shall be by an instrument in writing, signed and acknowledged by the trustee and filed with the records of the trust.
(C) The exercise of the power to invade principal of the trust under subsection (A) of this section shall not extend the permissible period of the rule against perpetuities that applies to the trust.
(D) The provisions of this section shall not be construed to abridge the right of any trustee who has a power of invasion to appoint property in further trust that arises under any other statute or under common law.

2. This should be true even if B dies within three years of the transfer between trusts, since B did not "relinquish" the power of appointment within three years of death, under Internal Revenue Code §2035(a). Beware, however, that elimination of a general power of appointment could in certain situations be detrimental for generation-skipping tax purposes.

3. NY EPTL §10-6.6; Alaska Code §13.36.157; Delaware Code §3528. Renowned New York attorney Jonathan Blattmachr was the author of the original legislation, and he says he based it on forms he used in his own documents for several years in order to create maximum flexibility. New York legislative history states its statute is declaratory of existing law, in order to fit within the generation-skipping tax (GST) regulations that define when an exercise of a power can cause loss of a trust's "grandfathered" status. In fact, absence of court or beneficiary approval is a prerequisite to GST grandfathering of a trust when the power can be exercised in further trust. Regulations §26.2601-1(b)(4)(i)(A).

4. For more information, see Halperin, "Decanting Discretionary Trusts: State Law and Tax Considerations," *Tax Management Estate, Gifts and Trusts Journal* (expected publication date August or September 2004).