

Insights & Commentary

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State Statutes Permitting Trustees to Decant Discretionary Trusts

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New York's EPTL §10-6.6(b),¹ enacted in 1992, was the first statute in the country to allow trustees to appoint trust property in further trust. In recent years, three other states--Alaska, Delaware and Tennessee--have passed similar statutes.² We expect other states to follow suit.

To assist state legislators, this commentary compares the different state decanting statutes. It further highlights issues to consider in drafting a trust pour-over statute.

A. New York EPTL §10-6.6(b)

The four prerequisites under the New York statute are: the trustee must have absolute discretion to invade the principal of the trust; the exercise cannot reduce the fixed income right of any beneficiary; the exercise of the power must be in favor of one or more of the proper objects of the power; and the new trust cannot include particular provisions that are considered to violate public policy.

B. Prerequisites Reflected in Other State Statutes

1. Authority to Invade Principal

New York's legislature established a high bar by including a requirement that the trustee of the original trust must have absolute discretion to invade the principal of the trust. Alaska's statute also requires absolute discretion as a prerequisite.³ The Delaware and Tennessee legislators, by comparison, loosened the requirement by requiring that the trustee merely have authority (as opposed to absolute discretion) to invade the principal of the trust.⁴

This reduced threshold makes the Delaware and Tennessee statutes more readily accessible. For example, if the existing trust permits invasion only in accordance with an ascertainable standard, the New York statute would not allow a pour-over to a new trust. The statutes in Delaware and Tennessee, in contrast, could be utilized. However, if the decanting trust (in Delaware or Tennessee) directs distributions pursuant to a standard, presumably the receptacle trust should have the same direction. Otherwise, the distribution to the new trust may be in contravention of the terms of the decanting trust. It further could defeat a beneficiary's fixed or ascertainable right. We therefore suggest that, if a decanting trust directs distributions based on a fixed or ascertainable standard, the statute should make it clear that the receptacle trust must contain the same mandatory provision.

2. Reduction of Income Interest

The New York statute requires that the exercise of the statutory power cannot reduce a fixed income right of any beneficiary.⁵ Delaware's statute has no such requirement. Again, Delaware's approach provides more flexibility. However, the absence of this requirement may jeopardize the marital deduction for estate and gift tax purposes. Theoretically, every QTIP trust governed by Delaware law is subject to the trustee's authority to diminish or reduce the spouse's income interest, unless the governing instrument overrides the Delaware statute.⁶ Out of an abundance of caution, we therefore recommend that the state statute include the New York provision prohibiting the reduction of a fixed income right. Aside from the tax consequence, the statute should not be able to undermine a beneficiary's fixed income right.

The statute also should protect other rights and benefits that a beneficiary may have under a decanting trust. For example, the amended Delaware statute provides that if a grantor makes any qualifying annual exclusion contributions to a decanting trust, the terms of the receptacle trust must provide that the beneficiary's interest vests as it would have under the terms of the decanting trust. Notably, neither the New York statute nor any of the other state statutes includes a provision to protect annual exclusion transfers. This provision, in our view, is a welcome addition.

We further recommend that the state statutes forbid a trustee from decanting a trust into a receptacle trust that eliminates a general power of appointment. The potential elimination of a general power of appointment could jeopardize the zero inclusion ratio, for generation-skipping tax purposes, of certain trusts.⁷

3. Proper Objects of the Power

Delaware and Tennessee replicated the requirement that the exercise must be in favor of "one or more of the proper objects" of the power. However, this phrasing is not ideal because it is unclear whether the term "proper objects" refers to the current income beneficiaries alone or the current income beneficiaries plus remaindermen. The Alaskan statute provides that the exercise must be in favor of "a beneficiary who is eligible or entitled to the income of the trust."⁸ Although Alaska's language seems to clarify the permissible beneficiaries of the receptacle trust, it raises a question as to whether the remaindermen of the existing and new trusts may be different.

Delaware legislators recognized the ambiguity of the phrase "proper objects." In an effort to clarify the identity of the "proper objects," they added an explanatory provision.⁹ Unfortunately, the provision is cumbersome and difficult to decipher.

C. Conclusion

The New York statute, subject to minor fine-tuning addressing the open issues, is a strong model. The Delaware and Tennessee statutes, which do not include the requirement of unfettered discretion to invade principal in the decanting trust, are more accessible. However, it is important that, for tax and non-tax reasons, any statute authorizing the pour-over to a new trust prohibit the trustee from defeating a beneficiary's fixed or ascertainable right.

For more information, in the Tax Management Portfolios, see 853 T.M., Fiduciary Liability of Trustees and Personal Representatives.

Footnotes

¹EPTL §10-6.6(b), L. 1992, Ch. 591, effective July 24, 1991 and applicable to all trusts whenever created.

²The generation-skipping transfer, gift, estate and income tax consequences of a trustee's exercise EPTL 10-6.6(b) are discussed in an article entitled "Decanting Discretionary Trusts: State Law and Tax Considerations," published in the September 2004 issue of the *Tax Mgmt. Estates, Gifts and Trusts Journal*.

³Alaska Stat. § 13.36.157 (1998).

⁴Del. Code Ann. 12 §3528 (2003); 2004 Tenn. Pub. Acts 537 § 74(b)(27).

⁵Although it would appear that a trustee may remove a beneficiary's future fixed income right (in contrast to a current fixed income right) via decanting into a new trust, it may be good form for the statute to confirm this point.

⁶It is true that the potential adverse tax consequence may differ depending on whether the offending provision appears in a state statute or in the governing instrument. Case law suggests that, at least in the context of §§2036 and 2038, a provision in a state statute will not endanger favorable tax treatment. *Helvering v. Helmholtz*, 296 U.S. 93 (1935); *Wyly v. Comr.*, 610 F.2d 1282 (5th Cir. 1980). However, it is unclear whether the IRS and courts would rely on these decisions to draw analogies in the decanting context.

⁷See §2642(c).

⁸Alaska Stat. §13.36.157(a).

⁹The new provision in the Delaware statute reads: "...Notwithstanding the foregoing provisions of this subsection (a), the governing instrument for the second trust may provide that, at a time or upon an event specified in the governing instrument, the remaining trust assets shall thereafter be held for the benefit of the beneficiaries of the first trust upon terms and conditions concerning the nature and extent of each such beneficiary's interest that are substantially identical to the first trust's terms and conditions concerning such beneficial interest." S. 289, 142nd Gen. Assem., § 2 (Del. 2004).