

Delaware Decantings

A Practical Guide to the Pitfalls and Perils

by
Kimberly Gill McKinnon
Morris, Nichols, Arsht & Tunnell LLP



Fifteen years ago Delaware enacted its decanting statute with the addition of Section 3528 to Title 12 of the Delaware Code. Decanting became part of a growing list of innovative laws that propelled Delaware into the leading jurisdiction that it is for the creation and administration of trusts.

Decanting may seem simple, but its execution can be complicated. This article will identify some of the most common “pitfalls and perils” encountered when exercising the decanting power.

The Basic Mechanics

Trust decanting earned its name by analogy to the decanting of wine. Decanting a trust involves “pouring” assets from one trust to another trust with more favorable terms. It is a valuable tool that enables the terms of an irrevocable trust to be modified. Among other things, a decanting could be used to add a direction or consent adviser, add a trust protector, grant or limit administrative powers, revise standards of liability, fix tax problems, change the governing law, change trustee succession provisions, extend the trust term, add confidentiality provisions, modify interests of current beneficiaries, or grant a power of appointment. The Delaware statute is available to any trust that is administered in the State of Delaware, even if the trust is actually governed by the laws of another jurisdiction.

Delaware’s decanting statute authorizes trustees that have the power to make discretionary distributions to beneficiaries of an irrevocable trust (the “first trust”) to instead appoint those assets in further trust (the “second trust”) for the benefit of one or more of those beneficiaries. Until recently, the

second trust had to be a completely new trust. The Delaware statute became even more flexible in 2017 when it was amended to allow property to be appointed back to the same trust, subject to modified terms.

Generally, a decanting must:

- (1) be in favor of a second trust having only beneficiaries who are currently eligible to receive distributions from the first trust (although the second trust may revert to the dispositive terms of the first trust at any time, thereby permitting the first trust's remainder to also be beneficiaries of the second trust); and,
- (2) comply with any standard that limits the trustee's authority to make distributions from the first trust.

Once these conditions are satisfied, a few rules and best practices come into play.

Interests of Remainder Beneficiaries Cannot Generally Be Changed

When analyzing a decanting transaction, it is helpful to group beneficiaries into two categories:

- (1) beneficiaries who are presently eligible to receive distributions from the trust, and
- (2) remainder beneficiaries who are typically not presently eligible to receive distributions from the trust.

Once the second group is identified, it is important to ensure that their beneficial interests are not changed by the decanting except to the extent subsumed by beneficiaries in the first group. Although the wording of the statute may seem confusing, the only option that the statute provides regarding the interests of beneficiaries in the second group is that at a time or upon an event specified in the second trust, the assets of the second trust 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 interests. It is important that the identities of such remainder beneficiaries remain entirely unchanged by the decanting. Furthermore, there should be no other changes from the first trust to the second that alter the "nature" or "extent" of such remainder beneficiaries' beneficial interests other than changes that defeat or limit remainder interests in favor of beneficial interests granted to beneficiaries in the first group.

Some common trust provisions might, if altered by the terms of a second trust in a decanting transaction, arguably affect the nature or extent of a remainder beneficiary's beneficial interest. Examples of such provisions include:

- (1) statements of a settlor's intent regarding distributions if the statements could be construed as binding,
- (2) manner of distribution provisions that identify permissible methods for making a distribution (*i.e.*, directly to a beneficiary's service provider or to a person with whom the beneficiary resides),
- (3) provisions that require a beneficiary to survive by a certain number of days,

- (4) holdback trusts for minors or incapacitated persons, and
- (5) early or small trust termination provisions.

In some cases, it may make sense to simply revert back to the terms of the first trust upon the death of the last of the current beneficiaries in order to avoid a possible violation of this rule.

Beneficiaries Cannot Be Added and Remainder Beneficiaries Cannot Generally Be Eliminated

Another rule to follow when structuring a decanting transaction is that no beneficiaries can be added by the decanting and no remainder beneficiaries can be eliminated except to the extent their interest is defeated or limited by the nature of the beneficial interests granted to beneficiaries in the first group. It is fairly easy to follow this rule in cases where only targeted provisions of the first trust are changed. However, in cases where the second trust is an entirely new form from the first trust, following this rule can be challenging.

It is not enough simply to compare the provisions describing the current and remainder beneficiaries of the first trust with the provisions describing the current and remainder beneficiaries of the second trust and make sure there have been no impermissible additions or eliminations. Numerous provisions throughout a trust instrument could potentially impact the identity of trust beneficiaries. Changing those provisions could add beneficiaries or change the identity of remainder beneficiaries in a way that is not always obvious. For example, if the trust is held for the benefit of someone's descendants, the definition of "descendants" or "issue" should not be changed in any way that *could* be construed in a manner that adds or eliminates beneficiaries in violation of the rule.

Another not-always-obvious example of a potential violation of this rule is the addition of the popular grantor trust power to add beneficiaries. The addition of such a provision may be tax-driven, but it probably violates the statute nonetheless. Consider also that if the law governing the trust's construction changes from the first trust to the second, the identity of the beneficiaries might change in a way that violates the decanting statute. For example, a baby born to same-sex spouses might be deemed the child of the non-biological parent under the laws of the jurisdiction governing the construction of the second trust, but not under the laws of the jurisdiction governing the first trust. If the descendants of the non-biological parent are beneficiaries of the trust, simply changing the law governing the trust's construction may have the unintended consequence of adding beneficiaries in violation of the statute. These are just a few examples among many that demonstrate possible difficulties in following this rule.

Additional Restrictions on Interests of Current Beneficiaries

A significant advantage of a Delaware decanting is that interests of current beneficiaries can be changed. Trusts can be divided, income interests and withdrawal rights can be defeated, trusts can be extended, beneficiaries can be eliminated, distributions can be limited... the list goes on.

(continued on p. 16)

(continued from p. 15)

Tax issues aside, various limitations arise when altering interests of current beneficiaries. In addition to the “no adding beneficiaries” rule discussed above, the decanting must also comply with any standard that limits the trustee’s authority to make distributions from the first trust. Thus, if the trustee can only make distributions to current beneficiaries for purposes of health, education, support, and maintenance, distributions to them from the second trust must generally be limited to those purposes or be subject to a narrower standard.

Another limitation is the rule that the decanting may not cause an “open class” of beneficiaries of the first trust to receive distributions sooner than when or in excess of the amounts permitted by the first trust. An “open class” is essentially a class of beneficiaries to which new members may be added in the future, such as someone’s descendants.

Powers of Appointment

Granting a power of appointment is another significant advantage of a Delaware decanting. Here are some issues to consider when granting, eliminating or altering power of appointment.

Since the nature and extent of the beneficial interests of remainder beneficiaries cannot generally be changed by a decanting, their powers of appointment should not be altered or eliminated and they should not be granted new powers.

Beneficiaries who are presently eligible to receive discretionary distributions can be granted a power of appointment, exercisable in favor of anyone (even non-beneficiaries), and their existing powers of appointment may be eliminated or altered. In practice, changing powers of appointment of current beneficiaries is not always without complication. It makes sense that if the trustee could have distributed the entire trust to the beneficiary in its sole discretion, the trustee should be able to grant the beneficiary a power to appoint the entire trust to anyone, as the statute clearly allows.

However, what if distributions are subject to an enforceable distribution standard? The statute provides that the decanting must comply with any standard that limits the trustee’s authority to make distributions from the first trust. Does the trustee have the power to grant a current beneficiary who only has an enforceable right to distributions for his education a power to appoint the entire trust to anyone? It may be that the most the trustee can do in this circumstance is to grant the beneficiary the following two types of powers of appointment:

- (1) the power to appoint trust property among current beneficiaries subject to the distribution standard, and
- (2) the power to appoint to anyone that amount that the trustee could have distributed to the beneficiary under the distribution standard.

Unfortunately, the answer to this question is not clear.

Other considerations have arisen with the recent passage of Section 3341 of Title 12 of the Delaware Code, which discusses various consequences of a trust decanting. Because that statute can give continuing effect to powers of appointment granted by the first trust, the decanting documents should expressly extinguish powers of appointment that the trustee intends to eliminate. Furthermore, in cases where the trustee is decanting property to a previously funded trust, the decanting instrument should expressly provide the extent to which powers of appointment will be exercisable over the property of the combined trust.

Tax Reimbursement Provisions

Tax reimbursement provisions are common in trust instruments, but caution should be used when adding one by decanting. It is not unusual to include a tax reimbursement clause that reimburses a grantor for the payment of income tax attributable to a trust classified as a “grantor trust” for tax purposes. However, adding such a provision by decanting arguably results in the addition of the grantor as a beneficiary of the trust.

Estate tax apportionment or reimbursement provisions may also be problematic. If, under the second trust the trustee may be responsible for greater estate tax obligations, in cases where trust property is includible in a beneficiary’s estate, than it would have been under the first trust or applicable law, could this be a violation of the decanting statute? A change that could result in the distribution of more trust property to a taxing authority, to the benefit of beneficiaries of the deceased beneficiary’s estate, may be an impermissible exercise of the decanting power. This issue is not clear.

The Enumerated List of Exceptions

The Delaware statute expressly prohibits the following three types of decantings:

- (1) a decanting that delays the time when a beneficiary’s remainder interest in a “minor’s trust” created pursuant to Section 2503(c) of the Internal Revenue Code vests and becomes distributable,
- (2) a decanting that reduces an income or unitrust interest of any beneficiary of a trust for which a marital deduction has been taken for federal or state estate or gift tax purposes, and
- (3) a decanting of property that is subject to a current withdrawal right held by a trust beneficiary who is the only beneficiary eligible for current distributions.

Trust fiduciaries should work with their advisers to ensure that the proposed transaction does not violate any of these rules or any similar restrictions added by changes to the law.

Comply with Formalities.

Decanting involves very few formalities, but the trustee must exercise its decanting power in a writing that is signed before a notary and file it with the records of the trust (although it is best to file with both trusts in the event that a new trust is created). Currently pending legislation would eliminate both the notarization and filing requirements. If the first trust requires that the trustee’s power to make discretionary distributions be

exercised at the direction of or with the consent of an adviser, then the trustee should also obtain the necessary consent or direction before proceeding with the transaction.

It is also good practice (but not required) to obtain release agreements from the beneficiaries before decanting a trust. As a practical matter, decanting is far more likely to be employed in the most advantageous manner if the distribution fiduciaries are adequately protected from liability for engaging in the transaction.

Conclusion

Although trust decanting can be structurally complicated, it is a very powerful tool. In many cases it will serve as the best, if not the only, option available to meet the objectives of a trust's beneficiaries and fiduciaries.



Kimberly Gill McKinnon is special counsel at Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Del. She represents numerous institutional fiduciaries, high net-worth individuals and families, and other attorneys in the areas of Delaware trust law and federal estate, gift and generation-skipping transfer taxation, as well as privately owned family companies and tax exempt organizations with respect to federal tax matters and formation and governance under Delaware law.

Copyright © Morris, Nichols, Arsht & Tunnell LLP. These materials have been prepared solely for informational and educational purposes, do not create an attorney-client relationship with the author(s) or Morris, Nichols, Arsht & Tunnell LLP, and should not be used as a substitute for legal counseling in specific situations. These materials reflect only the personal views of the author(s) and are not necessarily the views of Morris, Nichols, Arsht & Tunnell LLP or its clients.