

# **DECANTING-STRUCTURING TO MINIMIZE DISPUTES**

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# What is Decanting?

- A distribution of assets from one trust to another trust as a result of the exercise of a fiduciary's power (e.g., a Trustee action) to distribute income or principal
- The rationale underlying decanting is that a trustee who has the discretion to make an outright distribution of assets to or for a beneficiary has a special power of appointment over the assets of the trust, allowing the trustee to distribute the assets to another trust for the benefit of the beneficiaries
- Trustee's power to decant can be given by statute, common law, or in the governing instrument

# Authority for Decanting

## Statutory

- New York enacted the first decanting statute in 1992
- 37 states have statutes with 2 more having introduced legislation to enact statutes
  - Of the 37 states, 16 have enacted the Uniform Trust Decanting Act (UTDA) and 21 have their own individual statutes
  - Nebraska and Kansas enacted the UTDA. Arkansas, Iowa, Missouri, and Oklahoma have their own individual statutes.

## Common Law

- New Jersey and Massachusetts have only common law decanting authority (although Massachusetts has introduced legislation to enact the UTDA)

# Important Considerations

- (1) The overriding consideration is that an exercise of a trustee power is subject to all fiduciary duties and standards- trustee must act in good faith and in accordance with the purposes of the trust (intent of the settlor) even if the decanting statute otherwise allows the exercise
- (2) Extending the term of the trust - rules governing maximum perpetuity (Rule Against Perpetuities) that apply to the first trust will apply to the new trust, even if the decanting results in a change of governing law (e.g., the trust is moved to another jurisdiction with no RAP)
- (3) Grandfathered and GST tax exempt trust - consider possible GST tax implications of decanting (compliance with the safe harbor rules Treas. Reg. §26.2601-(b)(4)(i)(A) and/or in Treas. Reg. §26.2601-1(b)(4)(i)(D)
- (4) Understanding any income tax changes as a result of the exercise
- (5) Understanding the potential estate and gift consequences of the exercise (did the beneficiary's action or inaction result in an implied consent)
- (6) Would a Non-Judicial Settlement Agreement help protect the beneficiary and minimize disputes at least with the beneficiaries

# COMMON REASONS TO DECANT

- Address drafting errors or ambiguities, resolve interpretation questions
- Add or remove provisions for tax purposes – carry out Settlor's intent
- Extend trust terms to delay distributions
- Remove a beneficiary (tread lightly!)
- Provide successor trustees and trust protectors when trust instrument doesn't provide
- Change trust situs to avoid state income tax on trust income, asset protection planning
- Special Needs Trust language for qualification purposes
- Basis Step-Up Planning (see slides 9 and 10)

# TRUST MODIFICATION OPTIONS

- Non-Judicial Settlement Agreement (“NJSA”). This is a Uniform Trust Code (“UTC”) concept that is now available in most states.
- Trust Amendment by Settlor and All Beneficiaries
- Court action to Reform Trust
- Authorization Provided in Trust Instrument
- Decanting Transaction

# IS DECANTING THE BEST MODIFICATION OPTION?

- If the Trust Instrument provides a way to achieve the modification the best option is usually to rely on the authority provided in the Trust Instrument (such as action by a Trust Protector or Trustee).
- If the Trust does not provide authorization then a decanting exercise by the Trustee is a desirable way to achieve the modification provided the Trustee is willing to decant. Decanting does not require court approval (but a Trustee might ask the court to approve authority).



# DECANTING FOR BASIS PLANNING

- How to maximize both continuing changes to the transfer tax exemption and achieve basis step-up
- Trustee decants to a new trust by designating a trust protector who can have the ability to appoint a testamentary formula general power of appointment to a beneficiary (or later remove a general power, if necessary)
- The testamentary general power, if exercised, would appoint to one or more creditors of the beneficiary's estate and cause estate tax inclusion, thus allowing step-up in basis
- The mere existence of the power causes estate tax inclusion
- Confirm that under state law a creditor would have no rights to compel the exercise of the testamentary general power

# DECANTING FOR BASIS PLANNING CONTINUED

- Since the 2017 TCJA is scheduled to sunset in 2026 and also future legislation could change the transfer tax exemption the testamentary general power of appointment needs to be a formula
- The formula would provide that the general power of appointment would be effective only if the beneficiary does not have a taxable estate at death and the step-up basis laws when the beneficiary dies would benefit the estate

# **REVIEW OF CASES AND A RECENT IRS CCA**

- Cases Involving Divorce
- Special Needs
- Removal of Beneficiary, Grantor Intent
- IRS – Tax Consequences

# ***Ferri v. Powell-Ferri*, 72 N.E.3d 541 (Mass. 2017); 165 A.3d 1137 (Conn. 2017); 165 A.3d 1124 (Conn. 2017)**

## **Facts**

- Trust subject to Massachusetts law (no decanting statute)
- Beneficiary had power to withdraw a percentage of trust assets
- Beneficiary then obtains divorce
- Trustees decant assets to new trust for the benefit of the same beneficiary but with no withdrawal rights
- Decanting carried out to protect trust assets from divorce action

# ***Ferri v. Powell-Ferri, (cont'd)***

- 2014: Connecticut Superior Court invalidated the decanting
- Connecticut Supreme Court certified the case to the Supreme Judicial Court of Massachusetts:
  - Trustee had very broad discretion regarding distributions; trust instrument permitted decanting
  - Beneficiary's power of withdrawal did not limit decanting

# ***Ferri v. Powell-Ferri, (cont'd)***

## **Connecticut Supreme Court:**

- Decanted trust was not a self-settled trust by Beneficiary when Beneficiary was not involved in the decanting; trust assets were not marital assets
- Court did consider the trust assets in determining the amount of Beneficiary's alimony payments

## **Further thought:**

- Important that in Ferri case that the decanting occurred without husband's permission, knowledge or consent

# Decanting and Special Needs Trusts

## *Matter of Kroll v. New York State Department of Health*, 39 N.Y.S.3d 183 (Sup. Ct. 2016)

- Trust beneficiary had the right to withdraw assets at age 21
- Trustee decanted to special needs trust before beneficiary reached age 21
- New York Dept. of Health objected: decanting not effective until 30 days after execution as required by New York's decanting statute; 30 days after execution was after 21<sup>st</sup> birthday

## ***Kroll, (cont'd)***

- In Matter of Kroll v. New York State Dept. of Health, 39 N..S.3d 183 (2d Dep't 2016), court approved the decanting ruling that beneficiary was not the “creator” of a supplemental needs trust created by the decanting, where:
  - Beneficiary had not contributed any assets to original trust,
  - The decanting was accomplished prior to the beneficiary’s attaining the right to withdraw assets from the original trust, and
  - The supplemental needs trust did not grant any withdrawal rights to the beneficiary.
  - Thus, supplemental needs trust not required to include a “payback” provision in favor of the New York State Department of Health.



# Decanting and Special Needs Trusts

*Harrell v. Badger*, 171 So.3d 764 (Fla. Dist. Ct. App. 2015)

- Trustee decanted trust assets to a Florida pooled trust to assist beneficiary in qualifying for government benefits
- Remainder beneficiaries sued upon learning of the decanting 3 years later
- Court: Trustee did not comply with the notice requirement under the Florida decanting statute
- Court: Trustee added a beneficiary (the Florida pooled trust fund) in violation of the decanting statute

# ***In re Petition of Johnson, 2015 N.Y. Misc. LEXIS 51 (N.Y. Surr. 2015)***

- 1985: Wife establishes trust for Child and names Husband as trustee
  - Child was to receive all property at age 35
  - If Child died before age 35, Wife's family were remainder beneficiaries
- Husband and Wife divorce
- Independent party begins serving as trustee
- Trustee decanted assets to new trust:
  - Husband's family were remainder beneficiaries; Wife's family removed
- Court: decanting added beneficiaries in violation of New York decanting statute

***Matter of Hoppenstein*, 2017 N.Y. Misc. LEXIS 1707; 2017 NY Slip Op 30940(U) (N.Y. Surr. 2017); 2017 N.Y. Misc. LEXIS 3851 (N.Y. Surr. 2017)**

- Trustee had broad authority to distribute principal to settlor's descendants
- Distributions could exclude certain descendants in favor of other descendants
- Trustee could distribute principal "by payment to a trust for his or her benefit"
- Settlor became estranged from daughter, one of the trust beneficiaries
- Trustee decanted assets to new trust: daughter removed as beneficiary

# ***Matter of Hoppenstein, (cont'd)***

- Daughter objected, arguing that decanting violated the New York decanting statute
- Decanting upheld because it was carried out in accordance with the terms of the trust, which superseded the requirements of the decanting statute
- Decanting valid, even though it did not comply with New York's decanting statute because the trust instrument granted the trustees broad discretionary authority to make distributions of trust principal to the settlor's descendants, in equal or unequal amounts, and to any one or more of them to the exclusion of the others.

## **Trustee - Breach of Fiduciary Duty**

- In exercising the decanting power, a fiduciary is subject to the fiduciary duties that apply when exercising a discretionary distribution power. Uniform Act, Comments to Section 4.
- In order to avoid a breach of fiduciary duty, a trustee must consider whether a proposed decanting complies with its fiduciary duties, including trust purposes; duty of loyalty

## **Intent of Grantor – Trust Purposes**

- A trustee has a fiduciary duty to administer the trust in accordance with the purposes of the first trust. Uniform Act, Section 4(a).
- For decanting, does not require literal adherence, but the terms of the first trust instrument must inform the interpretation of the purposes of the trust.

## **Standard for Modification**

- The analysis of whether a decanting achieve the purposes of the first trust is similar to the analysis of whether a judicial modification of a trust is appropriate. Both emphasize the trust's purposes.
  - Circumstances not anticipated by settlor; modification would further purposes. UTC Section 412.
  - Continuation would be impracticable or wasteful or would impair the trust's administration. UC Section 412(a) & (b).

## **All Purposes Must be Considered**

- All purposes expressed in the terms or structure of a trust instrument should be considered by the fiduciary in order to determine whether the proposed decanting accomplishes the settlor's purposes.

## **Duty of Loyalty**

- Trustee's duty to administer the trust in the best interests of the beneficiaries and to act impartially, giving regard to the interests of all beneficiaries.
- Comments to Section 803 of the Uniform Trust Code:
- Does not require trustee to treat the beneficiaries equally.
- Rather, the trustee must treat the beneficiaries equitably in light of the purposes and terms of the trust.

# ***Hodges v. Johnson*, 177 A.3d 86 (N.H. 2017)**

## **Facts**

- Irrevocable trusts established in 2004 for settlor's then wife, children, step-children and other descendants
- Trustees: settlor's attorneys and an executive of a family business founded by the settlor
- Trustees: "distribute all or any portion of the net income and principal of the trust to any one or more of the group consisting of [the beneficiaries] and distributee trusts, in such amounts and at such times as the Trustee, in the Trustee's discretion, may determine."



# ***Hodges v. Johnson, (cont'd)***

## **Facts, continued**

- Distributee trusts: any trust under the trust instrument or any other trust established by the grantor; could be for the benefit of one or more, "but not necessarily all," of the beneficiaries.
- Settlor and other family members involved in dispute over family business
- Decanting: Eliminated some of the children and step-children (involved in the dispute) and settlor's now ex-wife
- Removed children and step-children brought suit

# ***Hodges v. Johnson, (cont'd)***

## **New Hampshire decanting statute:**

- If trustee has the power to make discretionary distributions of principal to one or more beneficiaries, the trustee may decant the assets to a new trust that eliminates one of those beneficiaries as a beneficiary of the new trust.
- Trustee has a duty to exercise the decanting power in a manner that is consistent with the settlor's intent as expressed in the terms of the trust, and the trustee shall act in accordance with the trustee's duties under [NH Uniform Trust Code (UTC)] and the terms of the first trust.
- Does not abrogate a trustee's duty to make distributions in good faith, in accordance with the trust terms and the interests of the beneficiaries.

# ***Hodges v. Johnson, (cont'd)***

- Trial court: set aside the decantings and removed the trustees; trustees did not consider the beneficial interests of the beneficiaries
- Supreme Court of New Hampshire
  - Trustees were subject to the duty of impartiality in carrying out a decanting
  - Trustees testified that they failed to consider the beneficial interests of the plaintiffs when they carried out the decanting

# ***Hodges v. Johnson, (cont'd)***

## **Supreme Court of New Hampshire**

- "a Trustee, who makes unequal distributions among beneficiaries and/or eliminates a beneficiary's non-vested interest in an irrevocable trust through decanting, violates the statutory duty of impartiality only when the trustee fails to treat the beneficiaries 'equitably in light of the purposes and terms of the trust.'" (quoting UTC 803 cmt (duty of impartiality))
- Violated duty of impartiality; failed to consider interests of all beneficiaries, both present and remainder

# ***Intent of Grantor***

**Morse v. Kraft – Boston Supreme Court, 466 Mass. 92 (2013) Common Law Authority State**

- Common Law Authority State
- Court relied on fundamental principles that in interpreting a trust, the intent of the settlor is paramount
- The court focused on the authority to distribute “for the benefit of” as evidence of the settlor’s intent that the trustee have authority to distribute in further trust
- The court admitted affidavits of the settlor, attorney/draftsperson and the trustee

## **Morse v. Kraft, (cont'd)**

- The court approved but cautioned that a more recent trust instrument without express decanting authority, may create a negative inference
- However the court declined (as requested in the Boston Bar Association amicus brief), to recognize an inherent power of trustees of irrevocable trusts to exercise their distribution authority by distributing property in further trust, irrespective of the language of the trust

# ***Potential Tax Consequences***

- Prior to exercising the decanting power, a trustee should evaluate the possibility of:
  - Income tax consequences, such as the possibility of a gain recognition event
  - Transfer tax consequences, such as a deemed gift due to beneficiary consent, or the involvement of
    - A trustee who is also a beneficiary, or
    - The grantor
  - Impact on grandfathered or exempt trusts

# **Estate of Horvitz v Commissioner, T.C. DKT. No. 20409-19 (Order Dated February 7, 2023)**

- The Tax Court rejected the IRS' refusal to respect an Ohio decanting and acceptance of an estate tax charitable deduction even though assets had been actually appointed to charity
- QTIP trusts were decanted to a trust that broadened the surviving spouse's testamentary power of appointment to appoint to charity
- Surviving spouse exercised her power upon her death in 2015 and appointed \$20 million to charity
- IRS said the trustee exceeded its power to decant because the distributions were subject to an ascertainable standard and thus not valid under Ohio law



## **Estate of Horvitz v Commissioner, (cont'd).**

- The trust instrument provided several clauses in the trust that supported that the trustee's powers exceeded the ascertainable standard.
- The litigation went on for eight years after the surviving spouse's death when the court ruled and agreed with the Estate that it was a valid decanting but said it didn't matter because the IRS didn't contest the decanting. The IRS then agreed to allow a full estate tax charitable deduction.
- The Estate eventually won but at a significant cost of time and litigation costs.

# **CCA 2023352018 (Nov. 28, 2023)– WILL THE CCA APPLY TO TRUST DECANTINGS**

- Concludes that the judicial modification of an irrevocable grantor trust, with beneficiaries' consent, to add a tax reimbursement clause providing the trustee the discretionary power to distribute income or principal to a grantor sufficient to reimburse for taxes paid by Grantor on trust income is a taxable gift by the beneficiaries
- The CCA specifically states that the IRS will follow Rev. Rul. 2004-64 which holds that if the original document provides for a tax reimbursement clause then a tax reimbursement distribution is not a gift by the beneficiaries
- The CCA provides no guidance on how to calculate the gift (the modification could actually benefit the beneficiaries as the tax reimbursement clause is better than the grantor turning off grantor trust status)
- What is concerning is the CCA specifically states that the result would have been the same if the beneficiaries had not explicitly consented but if they had received notice of the modification and failed to object to the modification (e.g., decantings)

# **In The Matter of the Niki and Darren Irrevocable Trust (2012 Trust) and The N and D Delaware Irrevocable Trust (2014 Trust) (Delaware Chancery Court, C.A. No. 2019-0302-GS- Decided 7/4/24)**

- Attempted decanting of assets in 2012 Trust (moved via situs from California to Delaware) to 2014 Trust. Delaware Chancery Court said decanting was a nullity
- Trustee was only able to distribute income of the 2012 Trust. Had no rights to invade the trust principal
- 2014 Trust (the decanted trust) changed the 2012 Trust by adjusting the share allocation of the beneficiaries and removed one of the beneficiary's right to income
- A Trustee cannot decant in Delaware if the Trustee has no rights to distribute principal even in the beneficiaries' consent to the changes

# **BONUS CASE ON TRUST PROTECTORS (NOT A DECANTING)**

## Undue Influence may be found over Trust Protector Design

- When Trust Protector is authorized to amend the Trust Instrument, indirect undue influence over Trust Protector's decision can be a cause of action if Trust Protector bases decision upon direction of the Settlor.
- Matter of ABB Trust Arizona Court interpreting the statutory language "was induced by undue influence" contained within AZ statute which is the same statutory language of MO statute and bears similarity to IL statute. 251 Ariz. 313 (2021).
  - Court examined undue influence of 3<sup>rd</sup> party of Settlor of Trust to direct Trust Protector to amend Trust.
  - Trust Instrument gave Trust Protector exercise powers in achieving Settlor's objectives.
  - Required Trust Protector to conduct a reasonable inquiry before exercising his powers.
  - Court found undue influence may be shown where 3<sup>rd</sup> party influences Settlor to exert pressure on Trust Protector to adopt an amendment to Trust Instrument.