

DECANTING AND PRIVATE SETTLEMENT AGREEMENTS

CINCINNATI ESTATE PLANNING COUNCIL

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I. DECANTING: OHIO'S STATUTE

A. Definition.

1. Decanting is pouring wine (or another liquid) from one container to another. At least 13 states have enacted statutes which allow a trustee who has broad discretion to make distributions or invasions of trust assets for a beneficiary to pay the trust assets from the distributing trust to another trust, the receiving trust, for such beneficiary. At least five other states are considering such legislation. Such statutes have been commonly called "decanting" statutes.

B. Common Law.

1. The Florida case, Phipps v. Palm Beach Trust Co., 142 Fl. 196 So. 299, 782, 196 So. 299, (1940) held that a trustee with absolute discretion to distribute the principal of a trust among a class of beneficiaries has an implied power to distribute the principal of the trust into a new trust for a member of the class of beneficiaries, rather than making the distribution directly to the beneficiary, "unless the donor clearly indicates a contrary intent." The Phipps case held that the trustee's absolute discretion could be exercised in further trust.

2. In addition to the Phipps case, the New Jersey case of Wiedenmayer v. Johnson, 106 N.J. Super. 161, 254 A.2d, 534 (Superior Court of New Jersey, Appellate Division, 1968) permitted the trustee, who had absolute discretion to distribute any or all of the trust property to the beneficiary to safeguard the beneficiary's best interests, to condition his distribution upon the beneficiary setting up a substituted trust.

3. A power to decant a trust may be useful for any number of purposes, including the following:

- (a) changing the termination date of the trust;
- (b) creating a special needs trust;
- (c) changing administrative provisions, including changing successor trustees, creating a power to remove the trustee, naming a trust protector, or modifying investment powers;
- (d) changing a trust's governing law;
- (e) facilitating tax planning, such as making a trust a grantor trust or a non-grantor trust; or changing a Crummey power;
- (f) granting a beneficiary a power of appointment;
- (g) dividing or combining trusts;

(h) making a trust a spendthrift trust.

4. Many trusts permit distributions to or for the benefit of a beneficiary. Such authority would seem to permit a distribution to a trust for such beneficiary. PLR 2005 30012 involved a matter where a state court confirmed that a trustee's authority to distribute "to or for the benefit of" a beneficiary permitted a distribution to another trust for the same beneficiary.

C. Statutes.

1. New York was the first state to enact a decanting statute. Since then, at least 12 other states, including Alaska, Delaware, Florida, South Dakota, and Ohio have adopted statutes.

2. One issue for consideration in drafting a decanting statute is what level of discretion a trustee must have to decant. The Phipps case permitted decanting when a trustee had absolute discretion, and the Wiedenmayer case involved a similar authority.

3. The new Ohio statute provides for a broader decanting power if the trustee has absolute power to make distributions and a more limited decanting power if the trustee's power is limited. Under the Ohio statute, the interest of the beneficiaries must not be materially changed in the recipient trust, if the distribution power is limited.

4. Under the Ohio statute, if the discretion is limited while the standards for distribution must be the same in the new trust as in the original trust, it seems likely that the new trust may alter ages for distribution, or change a trust to a life-time trust, subject to the same standard.

D. The Ohio Statute.

1. Section 5808.18(A) of the Ohio statute, is modeled after the Florida and New York statutes, and deals with a trustee who has absolute power to make distributions of principal. Absolute power is defined as a power to make distributions that is not limited by reasonably definite or ascertainable standards.

2. Section 5808.18(B) of the statute deals with a trustee who has authority to distribute principal to or for the benefit of one or more beneficiaries pursuant to a standard. Such a trustee may distribute part or the entire principal to a second trust, but the recipient trust may not materially change the interest of the beneficiaries of the original trust.

3. Section 5808.18(C) sets forth the limitations on the provisions of the recipient trust. The recipient trust may not: reduce or modify the current right of a beneficiary to a mandatory distribution of income or principal, or limit annual withdrawal rights. Section 5808.18(C)(1)(a).

4. The recipient trust may not include or omit provisions that would have disqualified the original trust for a marital or charitable deduction or reduce the deduction under the provisions under which the original trust qualified. Section 5808.18(C)(2).

5. The recipient trust may not include or omit provisions that would have prevented the original trust from qualifying for a gift tax annual exclusion in the manner in which the original trust did qualify. Section 5808.18(C)(3).

6. The recipient trust may not include or omit provisions that would have prevented the original trust from qualifying as an "S" corporation shareholder, if the original trust qualified. Section 5808.18(C)(4).

7. The recipient trust may not include or omit provisions that would have prevented qualification of the non-taxable gift exclusion for GST purposes, if the first trust so qualified. Section 5808.18(C)(5).

8. If the first trust is subject to the minimum distribution rules of Section 401(a)(9), the recipient trust may not include or omit provisions that would have shortened the maximum distribution period for distributions from qualified plans or IRAs. Section 5808.18(C)(6).

9. The recipient trust may not include or omit provisions that would have disqualified the original trust from any tax benefit for which the terms of the trust agreement expressly indicated intention of qualifying, or clearly designed to qualify. Section 5808.18(C)(7)

10. The recipient trust cannot increase the trustee's compensation. Section 5808.18(C)(8)(a).

11. The recipient trust cannot reduce the standard of care applicable to the trustee's action. Section 5808.18(C)(8)(b).

12. The trustee of the original trust is required to give notice to all of the current beneficiaries of the intended distribution to the recipient trust 30 days in advance of the distribution. Section 5808.18(F).

13. A spendthrift clause, or a provision prohibiting revocation or amendment of the trust, does not prevent the trustee from exercising its powers. Section 5808.18(H).

14. The trustee's decision, under the statute, is subject to a reasonableness and good faith standard. Section 5808.18(I).

E. Tax Considerations

1. Apart from the limitations in the statute, designed to preserve various tax attributes of the original trust, the Internal Revenue Service has issued a notice indicating that it is studying the tax implications of trust decanting. Notice 2011-101, 2011-52 I.R.B. 932, requested public comment on a list of tax issues and consequences arising from transfer of part or all of the principal of one trust to another trust that result in a change in the beneficial interest in the trust. The IRS indicated that it plans to issue published guidance on these issues and, in the meantime, will not issue private letter rulings with respect to such transfers. The IRS will continue to issue private letter rulings with respect to trust to trust transfers that do not change any beneficial interest and do not result in a change in the applicable rule against perpetuities.

2. The IRS identified a number of facts and circumstances that may affect one or more tax consequences, on which comments are requested, as follows:

- (a) changes in beneficiary's rights to income or principal;
- (b) addition of beneficiaries;
- (c) additions or deletions of powers of appointment;
- (d) shifting between grantor trust and non-grantor trust treatments;
- (e) change of situs or government law that extend the duration of a trust;
- (f) the requirement or absence of a requirement for, or actual acquisition of, a court ordered or beneficiary consent; and
- (g) distributions from a trust exempt from generation-skipping tax under the Effective Date rules, or that has an inclusion ratio of zero.

3. The deadline for submission of comments is August 25, 2012.

F. Response to the IRS Notice

1. One response to the IRS notice has pointed out that the trustee decanting power is based on the common-law, citing to the case of Phipps v. Palm Beach Trust Company, referenced above. The comment pointed out that if the reasoning in the Phipps case is sound, it is reasonable to believe that the common-law of every jurisdiction in the United States confers a decanting power on all trustees who have the power to invade trusts for the benefit of their beneficiaries. It was further pointed out that no U.S. court has held to the contrary.

2. A number of tax issues have been identified, including the following:

(a) Income Tax.

(i) is decanting a trust that is treated as a grantor trust, to a trust which is not a grantor trust, an income tax realization event?

(ii) should the distribution of property from one trust to another be treated as a distribution for purposes of Code Sections 661 and 662?

(iii) should the distribution of appreciated assets from one trust to another cause the distributing trust to recognize gain?

(iv) does the receiving trust carry over the tax attributes of the distributing trust?

(v) is the grantor of the distributing trust the grantor of the receiving trust following a decanting?

(b) There are a number of gift and estate tax issues, including the following:

(i) is a beneficiary whose interests are diminished as a result of decanting making a taxable gift?

(ii) is a beneficiary whose interests are diminished in a decanting making a transfer for purposes of Internal Revenue Code Sections 2036 and 2038?

(iii) does the generation-skipping tax protection of the transferring trust carry over to the receiving trust?

(iv) does the GST inclusion ratio of the distributing trust carry over to the receiving trust?

3. A number of these questions will remain uncertain until IRS guidance is issued. This will likely result in some reluctance to use decanting, which changes beneficial interest or carries tax risks until the IRS position is clarified.

G. Decanting Alternatives

1. Because of the lengthening or elimination of the common-law rule against perpetuities in many jurisdictions, long-term dynasty trusts have become very common, particularly in income tax favorable jurisdictions.

2. Given the longer term of many trusts, there are needs to revise irrevocable trusts to deal with unforeseen circumstances.

3. Decanting, while relatively new, is only one method of changing an irrevocable trust. Other alternatives include the following:

(a) a power granted in the trust agreement, either to a power holder, such as a trust advisor, or to a beneficiary, through a power of appointment;

(b) by agreement, such as by a private settlement agreement, in accordance with Section 5801.10 of the Ohio Revised Code;

(c) by a court order to modify a trust;

(d) by disclaimer;

4. As persons involved with the administration of existing trusts, we will all have occasion to deal with each of these methods. As we draft for clients who wish to assure that their strong desires are carried out, we need to keep in mind the possibility of the use of these devices and other devices to change trusts in the future, and to consider overruling those powers as we draft documents.

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