

Breathe new life into a “broken” trust by decanting it

Building flexibility into your estate plan using various strategies is generally advised. The reason is that life circumstances change over time, specifically changing tax laws and family circumstances. This is especially true during the COVID-19 pandemic. One such strategy to consider is decanting a trust.

“Decanting” defined

Decanting is pouring wine or another liquid from one vessel into another. In the estate planning world, it means “pouring” assets from one trust into another with modified terms. The rationale underlying decanting is that, if a trustee has discretionary power to distribute trust assets among the beneficiaries, it follows that he or she has the power to distribute those assets to another trust.

Depending on a trust’s language and the provisions of applicable state law, decanting may allow the trustee to:

- Correct errors or clarify trust language,
- Move the trust to a state with more favorable tax or asset protection laws,
- Take advantage of new tax laws,
- Remove beneficiaries,
- Change the number of trustees or alter their powers,
- Add or enhance spendthrift language to protect the trust assets from creditors’ claims, or
- Move funds to a special needs trust for a disabled beneficiary.

Unlike assets transferred at death, assets that are transferred to a trust don’t receive a stepped-up basis, so they can subject the beneficiaries to capital gains tax on any appreciation in value. One potential solution is to use

decanting. Decanting, for instance, can authorize the trustee to confer a general power of appointment over the assets to the trust's grantor. This would cause the assets to be included in the grantor's estate and, therefore, to be eligible for a stepped-up basis.

Follow your state's laws

Many states have decanting statutes and in some states, decanting is authorized by common law. Either way, it's critical to understand your state's requirements, such as, in some states, the trustee being required to notify the beneficiaries or even obtain their consent to decanting; others require neither. And some states prohibit decanting if the trustee has discretion over distributions of income but not principal, or if distributions are limited by an "ascertainable standard," such as a beneficiary's health, education, maintenance or support.

Even if decanting is permitted, there may be limitations on its uses. Some states, for example, prohibit the use of decanting to eliminate beneficiaries or add a power of appointment, and most states will not allow the addition of a new beneficiary. If your state doesn't authorize decanting, or if its decanting laws don't allow you to accomplish your objectives, it may be possible to move the trust to a state whose laws meet your needs.

Beware the tax implications

One of the risks associated with decanting is uncertainty over its tax implications. Let's say a beneficiary's interest is reduced. Has he or she made a taxable gift? Does it depend on whether the beneficiary has consented to the decanting? If the trust language authorizes decanting, must the trust be treated as a grantor trust? Does such language jeopardize the trust's eligibility for the marital deduction? Does distribution of assets from one trust to another trigger capital gains or other income tax consequences to the trust or its beneficiaries?

Don't try this at home

Decanting a bottle of wine — that is, pouring it into another container — helps to remove sediment and allows the wine to “breathe.” In the same vein, decanting can breathe new life into an irrevocable trust. Before acting, consult with your estate planning advisor.

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