

FIXING OLD TRUSTS AND EXPLOITING NEW OPPORTUNITIES:

FLORIDA'S DECANTING STATUTE

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Many planners confront situations involving clients who have created one or more irrevocable trusts that, for any number of reasons, no longer reflect the clients' objectives. For example, the existing trust may provide for outright distributions to a beneficiary and the clients may have concerns as to the property passing outright to a beneficiary that is too young, or who is currently experiencing creditor issues, going through a divorce or receiving government benefits. Alternately, changes in the tax law may cause provisions that were previously thought to be appropriate and beneficial when the trust was initially drafted to have unforeseen negative tax implications. Florida's recently enacted "decanting" statute (Section 736.04117) provides what many advisors correctly see as an invaluable mechanism to help ensure that the clients' objectives are achieved. As the name implies, it can be pictured like decanting wine – pouring the assets of one trust into another trust. It is not applicable to all trusts, and the terms and conditions of the trust must be carefully analyzed to ensure that the statute can be used (basically, only when the trustee has the absolute power to invade principal). The "recipient" trust must have one or more of the same beneficiaries as the "pouring" trust. Even though the decanting statute is a powerful tool, it is not a panacea and planners should be cautious when employing it so to ensure that they do not inadvertently trigger unintended adverse tax consequences. Moreover, while decanting offers trustees flexibility in modifying trust terms, it is important not to contravene a settlor's intent for the trust.

I. **Reasons to Decant.** Trust decanting can be used to correct a variety of issues, such as the following:

A. **Outright Distributions.** A trust may provide for outright trust distributions to be made to the trust beneficiaries at a given age. While a direction to make an outright distribution to a beneficiary may have seemed appropriate at the time the trust was drafted, it may now be less acceptable if the assets have significantly appreciated in value or if the beneficiary has creditor or estate tax issues or if the beneficiary is going through a divorce or has an addiction of some kind. Additionally, the trust may be wholly exempt from generation skipping transfer tax ("GSTT") and an outright distribution to the beneficiary will subject those assets to transfer tax in the future.

B. Correct Drafting Errors. Drafting errors might be discovered long after a trust has become irrevocable and decanting may offer an opportunity to correct these errors through transferring the assets to a newer, better drafted trust. Similarly, tax laws may change over time, affecting the desirability or ramifications of having specific provisions contained in the trust. It may be possible to use decanting to help avoid adverse tax ramifications.

C. Spendthrift Protection. A trust may lack a valid spendthrift provision, which could expose the trust assets to the beneficiary's creditors. Moreover, if the assets are subject to claims of beneficiary's creditor's, those assets would also likely be included in the beneficiary's estate for estate tax purposes.

D. Disability of Beneficiary. A trust may need to be converted into a special needs trust so as to ensure that a disabled beneficiary does not lose any governmental benefits to which the beneficiary would otherwise be entitled.

E. Liquidity and Expenses. Two or more trusts may exist with similar or identical terms for the benefit of the same beneficiary or beneficiaries. However, one such trust may own only a life insurance policy on the life of the settlor (a typical irrevocable life insurance trust) and have a need to pay annual premium payments to keep the policy in force while another one of the trusts may have an abundance of liquidity. Through decanting (or merger) it may be possible to transfer the assets of the highly liquid trust into the life insurance trust (or vice versa) to help ensure that the insurance premiums can be satisfied. Similarly, the consolidation of trust assets into one trust may help to reduce or eliminate any ongoing administrative expenses.

F. Trustee Provisions. Decanting may be used to grant or eliminate a power to remove and/or replace a trustee or to change the order of trustee succession. It may also be used to modify terms relating to trustee compensation and to grant additional investment powers that many corporate fiduciaries now require.

G. Trust Protector. It may be desirable to decant and transfer trust assets to a new trust that has a trust protector in order to afford greater flexibility.

H. Governing Law. The existing trust may benefit from being moved to another state and being governed under that state's statutory regime. Unfortunately, many older trusts do not grant a trustee the right or authority to relocate the trust situs or change the law that otherwise applies to the trust. Decanting would allow a trustee to transfer the trust assets to a new trust governed by the laws of a desired state.

I. State Income Taxes. A trust may have been organized in a state with an income tax, and the desire is to shift the assets to a trust situated in state with no income taxes.

II. Requirements for Decanting. In order for a trustee to decant from one trust (the "First Trust") to another trust (the "Second Trust"), the First Trust must meet the following statutory requirements:

A. Absolute Power. The trustee must have the *absolute power* to invade the principal of the First Trust. The statute clarifies that a power to invade trust principal for purposes such as a beneficiary's best interests, welfare, comfort or happiness constitutes an "absolute power". A power to invade trust principal based solely on an ascertainable standard (e.g., health, education, maintenance and support) will not be considered an absolute power. A spendthrift provision in the First Trust does not affect a trustee's power to decant.

Florida's decanting statute is actually a codification of Florida common law dating back to 1940. Under *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940), the Florida Supreme Court ruled that an independent trustee who has both a lifetime and a testamentary power to direct distributions of trust property to the trust beneficiaries may instead direct that a second trust be created for the benefit of those beneficiaries and that assets from the first trust be distributed to the second trust.

B. Fixed Income, Annuity or Unitrust Interests. The decanting power cannot be used to reduce any fixed income, annuity or unitrust interest in the First Trust. This is designed to protect a charitable or marital deduction. Similarly, the statute contains a provision indicating that if the First Trust qualified for a marital or charitable deduction, then the Second Trust cannot contain a provision that would have prevented the First Trust from qualifying for that deduction.

C. Beneficiaries. The decanting power must be exercised in favor of one or more beneficiaries of the First Trust to whom the trustee has the absolute power to make distributions of trust principal. Note that not all of the beneficiaries of the First Trust need to be beneficiaries of the Second Trust. However, each beneficiary of the Second Trust must have been a beneficiary of the First Trust. For example, if the trustee of the First Trust has the absolute power to make distributions to beneficiaries A, B and C, then the trustee may decant and distribute the assets of the First Trust to a Second Trust for the benefit of A, B and/or C but cannot decant to a Second Trust for the benefit of A and D because D was not a beneficiary of the First Trust.

III. Mechanics of Decanting.

A. Notice. The trustee of the First Trust is required to provide all the qualified beneficiaries of the First Trust with written notice of the trustee's intention to decant at least 60 days prior to the effective date of the trustee exercising his or her decanting power. The qualified beneficiaries have the right to waive this requirement.

B. Written instrument. A written instrument that is signed and acknowledged by the trustee of the First Trust must be filed with the records of the First Trust.

IV. Tax Consequences of Decanting.

A. Generation Skipping Transfer Tax. There is always a concern that decanting to another trust so as to extend the duration of an otherwise GSTT exempt trust will taint the trust and cause a portion of it to be non-exempt. Treas. Reg. § 26.2601-1(b)(4)(i)(A) provides that extending the duration of a GSTT exempt trust will not taint the trust if: (1) authority for the trustee to appoint in further trust existed at the time the exempt trust became irrevocable (under *Phipps* that would likely mean after 1940), (2) the trustee is able to exercise his or her authority to decant without the consent or approval of any beneficiary of court, and (3) the terms of the governing instrument of the Second Trust do not extend the time for vesting of any beneficial interest in the trust beyond 21 years plus a life in being on the date the First Trust became irrevocable. (Note that while this regulation applies to trusts that are grandfathered in because they were created prior to 1986, it should also apply to trusts that are exempt because of a GSTT allocation. See PLR 200919009.) Under this Regulation, a trustee cannot simply extend the duration of a GSTT exempt irrevocable trust (or delay the date on which the trust principal is to be distributed outright to a beneficiary) without possibly forfeiting the trust's GSTT exempt status. It would seem possible that the trustee could exercise his or her decanting power to a Second Trust that requires the property to be distributed outright upon the earlier of: (1) 21 years plus a life in being on the date the First Trust became irrevocable, and (2) the maximum period permissible without causing the trust will have an inclusion ratio of greater than zero. The difficulty of using this approach is that the trustee very likely will not know when the trust expires, nor when GSTT is due.

Even if the decanting power did not exist at the time the First Trust became irrevocable, the trustee can still decant without jeopardizing the trust's GSTT exempt status if (1) the exercise of the power does not cause a beneficial interest in the trust assets to be shifted to a beneficiary in a lower generation for GSTT purposes, and (2) the distribution to the Second Trust does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the First Trust. See Treas. Reg. section 26.2601-1(b)(4)(i)(D)(1). Decanting to a new trust to prevent trust principal from being distributed outright to a beneficiary would violate this safe harbor. However, the Regulations clarify that administrative changes will not taint the GSTT exempt status of a grandfathered trust.

It is presently unclear what the actual tax consequences are if the GSTT exemption is lost. If the decanted trust was already being held for a skip person (the "existing skip person"), then it is possible that all future distributions from the trust will be subject to GSTT. It is also possible that future distributions to the existing skip person will remain exempt but that any distributions to beneficiaries a generation below the existing skip person will be subject to GSTT and that the death of the existing skip person will be a GSTT event.

B. Gift and Estate Tax. If the trustee exercising the decanting power is not also a beneficiary of the trust and the beneficiary's consent is not required to decant, then the trustee's exercise of his or her decanting power should not be treated as a taxable gift. It is possible that the IRS will argue that the beneficiary should have objected to the trustee's attempt to decant and that the beneficiary has therefore made a gift. However, this seems like a very tenuous argument where the beneficiary's consent is not required. To minimize the risk of the IRS raising this argument, it may make sense to grant the beneficiary a limited power of appointment over the assets of the Second Trust. The power of appointment should render the purported gift incomplete for transfer tax purposes. See Treas. Reg. § 25.2511-2(b) and PLR 200715005. Note: If the beneficiary is deemed to have made a gift and if that gift is incomplete due to the beneficiary's power of appointment, then the trust property will be included in the beneficiary's estate under Code §§ 2036 and 2038. However, if the beneficiary is considered to have made a gratuitous transfer to the Second Trust (in which the beneficiary has retained a beneficial interest), then the trust assets are likely includible in the beneficiary's estate irrespective of whether the beneficiary has retained a power of appointment if the transfer otherwise fell under Code §§ 2035, 2036, 2037, 2038, 2039 or 2042.

C. Income Tax. Decanting should generally be a neutral event for federal income tax purposes. Note, however, that where the property of the First Trust consists of one or more negative basis assets (a negative basis asset is an asset that has a liability exceeding the trust's income tax basis in the asset), it is unclear whether gain will be recognized under *Crane v. Comm'r*, 331 U.S. 1 (1947). There is not clear law as to whether a trust or an estate realizes gain when it distributes a negative basis asset to a beneficiary and, as such, the law remains just as unclear in terms of decanting. However, there is gain as to any negative basis assets if a settlor trust is converted to a nongrantor trust during the settlor's lifetime. See Treas. Reg. § 1.1001-2(c), Example 5; *Madorin v. Comm'r*, 84 T.C. 667 (1985) and Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 JTAX 149 (Sept. 2002). However, Code § 643(e) provides that trust distributions generally do not trigger gain unless the trustee elects to trigger gain. If the First Trust and the Second Trust are both grantor trusts for income tax purposes, then all of these concerns should be avoided, as they are generally ignored for income tax purposes. See Rev. Rul. 85-13 and Rev. Rul. 2007-13.

If the decanting transfers appreciated assets to a foreign trust, then the transfer shall be treated as a sale or exchange for income tax purposes under Code § 684. However, if the Second Trust is a grantor trust for income tax purposes, then there will be no deemed sale or exchange at the time of decanting and the sale or exchange will only be deemed to occur once grantor trust status terminates. See Code § 684(b) and Treas. Reg. § 1.684-2(e)(1). If the First Trust is a foreign trust and the Second Trust is a domestic trust, then the distribution should be a reporting event under Code § 6048. See Form 3520.

V. Other Methods of Trust Modification. While decanting is a powerful device for planners to consider when confronted with an irrevocable trust that no longer achieves (or possibly never achieved) the client's objectives. However, given the statutory and/or common law requirements for decanting (e.g., that the trustee must have the absolute power to make distributions), decanting may not always be an option. Fortunately, Florida law affords several other methods of modifying an irrevocable trust that a planner might be able to use to achieve a favorable outcome for the client.

A. Statutory Options.

1. Judicial Termination or Modification.

a. *Judicial Termination or Modification of any Trust.* Section 736.04113 of the Florida Statutes provides that an irrevocable trust may be judicially modified or terminated when: (i) the purposes of the trust have been fulfilled or have become illegal, impossible, wasteful, or impracticable to fulfill; (ii) because of circumstances not anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust; or (iii) a material purpose of the trust no longer exists. In modifying a trust under this section, the court may: (i) amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust; (ii) terminate the trust in whole or in part; (iii) direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust; or (iv) prohibit the trustee from performing acts that are permitted or required by the terms of the trust.

b. *Judicial Termination or Modification of Trusts Created after 2000.* Section 736.04115 of the Florida Statutes provides for judicial termination or modification of any trust created after December 31, 2000, when such modification is in the best interest of the beneficiaries. In determining whether to modify a given trust, the court is to consider the following: (i) the terms and purposes of the trust; (ii) the facts and circumstances surrounding the creation of the trust; (iii) extrinsic evidence relevant to the proposed modification; and (iv) any spendthrift clause contained in the trust. The court shall exercise its discretion in a manner that conforms to the extent possible with the intent of the settlor, taking into account the current circumstances and best interests of the beneficiaries. For purposes of this section, a revocable trust is treated as created when the settlor's right of revocation terminates. This section does not apply to any trust that provides that all beneficial interests in the trust must terminate within the period prescribed by the rule against perpetuities in § 689.225(2) of the Florida Statutes (no later than 21 years after the death of an individual living at the time the trust is created or within 90 years after the trust is established), nor does it apply to any trust that specifically prohibits judicial modification.

c. *Trust Reformation.* Section 736.0415 of the Florida Statutes provides that a settlor or any interested person may petition the court to reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intent if it is proved by clear and convincing evidence that both the accomplishment of the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement. In determining the settlor's original intent, the court may consider evidence relevant to the settlor's intent even though the evidence contradicts an apparent plain meaning of the trust instrument.

d. *Modification to Achieve Tax Objectives.* Section 736.0416 of the Florida Statutes permits any interested person to petition the court to modify the terms of a trust to achieve the settlor's tax objectives in a manner that is not contrary to the settlor's probable intent. The court may provide that the modification has retroactive effect.

2. Non-Judicial Modification.

a. *Nonjudicial Settlement Agreements.* Section 736.0111 of the Florida Statutes permits all of the trustees and beneficiaries of a trust to enter into a nonjudicial settlement agreement to resolve any one or more of the following issues: (a) the interpretation or construction of the terms of the trust; (b) the approval of a trustee's report or accounting; (c) the direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power; (d) the resignation or appointment of a trustee and the determination of a trustee's compensation; (e) the transfer of a trust's principal place of administration; and the liability of a trustee for an action relating to the trust. A nonjudicial settlement agreement among the trustee and trust beneficiaries is valid only to the extent the terms and conditions could be properly approved by the court. A nonjudicial settlement may not be used to produce a result not authorized by other provisions of the Florida Trust Code, including, but not limited to, terminating or modifying a trust in an impermissible manner.

b. *Unanimous Agreement.* Section 736.0412 of the Florida Statutes provides that after the settlor's death, the trustees and beneficiaries of a trust may modify the trust by unanimous agreement in any of the following ways: (a) amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust; (b) terminate the trust in whole or in part; (c) direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust; or (d) prohibit the trustee from performing acts that are permitted or required by the terms of the trust. This section only applies to any trust created after December 31, 2000. For purposes of this section, a revocable trust is treated as created when the settlor's right of revocation terminates. This section does not apply to any trust that provides that all beneficial interests in the trust must terminate within the period prescribed by the rule against perpetuities in § 689.225(2) of the Florida Statutes (no later than 21 years after the death of an individual living at

the time the trust is created or within 90 years after the trust is established), unless the trust specifically provides for the applicability of this section. Additionally, this section may not be used to modify a trust for which a charitable deduction is allowed or allowable under the Code until the termination of all charitable interests in the trust.

c. *Merger and Division.* Section 736.0417 of the Florida Statutes provides that a trustee, after notice to the qualified beneficiaries, may combine two or more trusts or divide a trust into two or more separate trusts, if the result does not impair the rights of any beneficiary or adversely affect achievement of the purposes of the trusts or trust. The effective date of the severance may be retroactive to a date before the date on which the trustee exercises such power.

d. *Termination of Uneconomical Trusts.* Section 736.0414 of the Florida Statutes provides that a trustee may terminate a trust if the total value of the property held by the trust is less than \$50,000 and does not justify the cost of administration.

B. Common Law Options. The statutory judicial and non-judicial modification and termination provisions provide that they are in addition to, and not in derogation of, rights under common law to modify, amend, terminate or revoke trusts that existed prior to the adoption of the foregoing statutes.

1. Judicial Termination. A court may order termination of a trust at common law only when the purpose for which the trust was created has been accomplished or is impossible to accomplish. *Featherston v. Tompkins*, 339 So. 2d 306 (Fla. 3d DCA 1976) (involving a testamentary trust) and *City of Islandia v. Metropolitan Dade Cnty*, 362 So. 2d 385 (Fla. 3d DCA 1978) (relating to an inter vivos trust). A trust may not be terminated by court order prior to the expiration of a specific term or duration expressed in the trust. *Schwarzkopf v. American Heart Assn. of Greater Miami, Inc.*, 541 So. 2d 1348 (Fla. 3d DCA 1989).

2. Judicial Modification. It appears that a court may modify an inter vivos trust for a scrivener error, so long as the modification is not contrary to the interests of the settlor. *Robinson v. Robinson*, 720 So. 2d 540 (Fla. 4th DCA 1998) (noting that while modification of an inter vivos trust may be possible, modification of a testamentary trust is not). However, it appears that a court cannot modify or reform a trust for the unilateral mistake of the settlor. See *Providence Square Assn., Inc. v. Biancardi*, 507 So. 2d 1366 (Fla. 1987) and *Ayers v. Thompson*, 536 So. 2d 1151 (1st DCA 1988). Additionally, a court may modify the terms of a trust only in an emergency situation in which action by the court is indispensable to the preservation of the trust. *Pentland v. Pentland*, 113 So. 2d 872 (Fla. 2d DCA 1959). It should be noted that the *Pentland* case was unique and involved a trust established pursuant to a divorce decree.

3. Non-Judicial Termination. The settlor and all beneficiaries of a trust have the power to terminate an irrevocable trust by consent. *Preston v. City Nat'l Bank of Miami*, 294 So. 2d 11 (Fla. 3d DCA 1974) and *Smith v. Mass. Mut. Life Ins. Co.*, 156 So. 498 (Fla. 1934) (dicta in both).

4. Non-Judicial Modification. The settlor joined by all the beneficiaries of an inter-vivos irrevocable trust may modify it by consent. *Preston v. City Nat'l Bank of Miami* (dicta). Note that while *Preston* is frequently cited for this proposition, the actual instrument involved there was merely a voluntary assignment of rights to principal of the trust. A settlor of an irrevocable trust has the right to modify an inter vivos trust by surrendering privileges or rights in favor of the trust beneficiaries without the beneficiaries' consent. *Sieley v. Bieley*, 398 So. 2d 932 (Fla. 3d DCA 1981).

C. Tax Issues Relating to Trust Modifications.

1. Gift Tax and GSTT Issues. If, in the context of a judicial or non-judicial modification, a party permits his or her interest to be shifted to another person, then there is the possibility that the party losing or forfeiting his or her interest will be viewed as making a gift under the Code. If such an agreement is non-collusive and is in the settlement of bona fide litigation, then it will likely not be viewed as a gift. See *Comm'r v. Vease*, 314 F.2d 79 (9th Cir. 1963) and *Grossman v. Campbell*, 368 F.2d 206 (5th Cir. 1966). Additionally, if the beneficial interest is shifted to a lower generation, then a trust that is otherwise GSTT exempt, may lose its exempt status. See Treas. Reg. §§ 26.2601-1(b)(4)(D) and 26.2601-1(b)(4).

2. Effect of Judicial Modification or Termination. In the context of a judicial modification, there is also a question of whether a federal court will respect a state court's order modifying or terminating the trust. "In the absence of an authoritative decision by the highest state court, the federal court [and federal tax authorities (e.g., the IRS)] must give "proper regard"—but not conclusive force—to decisions of the state's trial and intermediate appellate courts when determining, as best it can, how the local issue would be decided by the highest state court." See ¶ 4.1.5 Effect of Income Tax and State Law, Bittker & Lokken: Federal Taxation of Income, Estates, and Gifts.