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Worth It Episode 8: Decanting to Modify an Existing Irrevocable Trust

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In this episode of Worth It, Proskauer associates Jacob Wonn and James Muller discuss the idea of "decanting" irrevocable trusts and what that means for clients. Clients who have assets that might pass outright to their descendants may consider decanting to extend the term of the trust and provide additional management benefits and creditor protection to their descendants. So be sure to tune in and see why clients may consider decanting trusts that they have already formed.

Jacob Wonn: Hello and welcome to Worth It, a podcast brought to you by Proskauer's Private Client Services group, covering a wide range of topics concerning estate planning, wealth transfers, important legal developments and other issues our clients frequently face when organizing their estates. My name is Jacob Wonn. I'm an associate at Proskauer's New York office and in this episode we will be discussing the idea of decanting irrevocable trusts, what that idea means, and why clients might consider decanting trusts that they have already formed. Joining me for this episode is James Muller, another associate in Proskauer's New York Office. Welcome, James.

James Muller: Hi, Jacob. Happy to be here.

Jacob Wonn: Thanks for joining today, James, and let's start from the beginning. What is decanting?

James Muller: Well, I think it makes sense to start one step prior to decanting and clarify when decanting can be a possibility. Trusts can either be revocable or irrevocable. An irrevocable trust is one that the creator or settlor can change, amend, or revoke at any time. Conversely an irrevocable trust is a trust that cannot be revoked or changed. While irrevocable trusts cannot be revoked, they can be modified in certain ways through the process of decanting. The decanting term refers to the pouring of assets of one irrevocable trust into another irrevocable trust, just like how a bottle of wine might be poured or decanted into another vessel. Decanting is a possibility for many but not all irrevocable trusts as a way to modify the terms of the trust to be more appropriate for the current circumstances.

Jacob Wonn: That's a decanting generally. The idea is to move the assets from one irrevocable trust to another in order to change the terms of the first trust. So when is that a possibility?

James Muller: In most jurisdictions the basic requirement for decanting is that trustees have discretion to pay principle of the original trust to one or more beneficiaries. Under the common law, which still applies in some jurisdictions, the trust can only be decanted if the trustee has absolute discretion to distribute principle where the trustee can distribute principle for any reason. In other words, if a trustee can only distribute principle for beneficiaries' health, maintenance, and support, it may not be possible to decant the trust depending on the applicable governing law. Other states, like New York, allow decanting when the trustee has limited discretion to distribute principle to a beneficiary. But when the trustee has limited discretion, there tend to be limits on the types of modifications that can be made in the new or continuing trust.

Additionally, the trust agreement itself may specifically authorize trustees to decant by paying principle to another trust for the benefit of the same beneficiaries. The main limitation where irrevocable trusts cannot be decanted is if the original trust only allows for income to be distributed but does not allow for principle distributions. In that case, decanting is not possible but there may be other ways to modify the trust to meet a client's needs.

Jacob Wonn: That's helpful. Let's come back to other ways to modify an irrevocable trust. When you review irrevocable trusts that a client already created, what are some of the main reasons that you would suggest that those existing trusts be decanted?

James Muller: A client can modify an existing irrevocable trust by decanting. First, we often decant an existing trust to extend the term of the trust. The client's trust may provide for outright distributions to a beneficiary at a certain age with the client's death. If the client wants the beneficiary to have assets in his or her own name at that point, then it is fine to leave the trust as is. However, we frequently recommend leaving assets in trust for as long as possible to provide the beneficiary with ongoing creditor protection. The beneficiary can still have indirect control over the trust by being trustee or having the right to remove and replace trust. But by keeping the assets in trust, the assets generally are not subject to claims against the beneficiary, including claims in a beneficiary’s divorce. Second, I have decanted many trusts to change the age or circumstances where a beneficiary gets control of the trust.

For example, an existing trust may allow a beneficiary to act as trustee or change trustees of his or her trust at age 40. But the client now realizes that the beneficiary is 35, very responsible, and sees no reason he or she should not control the trust at this point in time. As always, the opposite can be true, and a settlor might see that his or her 39 year old child is not sufficiently responsible to control the assets in a year. In either case the existing trust can be decanted to a new trust that provides the beneficiary with indirect control at a more appropriate time.

The third reason we frequently decant a trust is to remove a beneficiary. Existing trusts may have been created before the client had children, so a brother or sister was named as beneficiary but it no longer makes sense to involve the brother or sister in the trust administration. Sometimes the client may have also had a falling out with the child or another beneficiary. By decanting, the new trust can remove a beneficiary from the class of people who were beneficiaries of the original trust. However, decanting generally cannot be used to add a beneficiary to the original trust. Of course clients may want to decant for any other reasons specific to their circumstances as well. And if they do, we try to find ways to accomplish the client's goals.

Jacob Wonn: Great. Thanks for walking us through that, James. Before we wrap up, I wanted to follow up on something you said earlier, that if a trust cannot be decanted but the circumstances have changed what are some other ways to modify an irrevocable trust?

James Muller: Well, Jacob, it depends on the jurisdiction and the circumstances but there are a few options we frequently consider. Many states allow for a court to modify a trust upon a petition by one or more interested parties. Like any court proceeding, this process can be significantly simpler if all of the parties are in agreement about how the trust should be modified. Many states also have statutes that allow a trust to be converted into a unitrust under some circumstances. Generally, this is applicable where the trust only allows for the payment of income which might happen if the trust was intended to qualify for the estate tax marital deduction. By electing to treat the trust as a unitrust, the amount of distributable is determined based on the total fair market value of the trust's holdings rather than simply on the amount of income earned by the trust. Historically, this tool has been particularly helpful when there is a disagreement between the income beneficiary and remainder beneficiaries regarding the administration of the trust, because the unitrust allows both sides to benefit from all trust investments.

Jacob Wonn: Thanks, James. So, you know, we've talked about situations where you can decant an irrevocable trust and potential alternatives to decanting. One last thing I was curious about is whether there are any common situations you can think of where you would be permitted to decant an irrevocable trust but it might be inadvisable or problematic for some other reason.

James Muller: Well, Jacob, one circumstance in which you want to be careful about decanting is where assets transferred to the original trust were transferred before the generation skipping transfer tax rules came into effect. Generally this would be transfers that were made before 1985, but that could be a podcast of its own.

Jacob Wonn: Got it! Thanks, James. It's great to know that there are these options available for modifying existing irrevocable trusts. Thanks for coming on Worth It today and discussing decanting with us and why clients might consider decanting their existing irrevocable trusts.

In particular, clients who have assets that might pass outright to their descendants may consider decanting to extend the term of the trust and provide additional management benefits and creditor protection to their descendants. Also, clients who want their descendants to have indirect control over a trust at an earlier or later date than is provided in the existing trust may consider decanting.

Finally, clients who may want to cut out certain beneficiaries from an existing trust could consider decanting to a new trust that does not include that individual as a beneficiary.

It's also helpful that there are other ways to modify irrevocable trusts that may not be able to be decanted, though again exercise extreme caution when thinking about decanting all the grandfathered trusts from before 1985 or so that are exempt from generation skipping transfer tax. I think that about does it for today. Thank you, James.

James Muller: My pleasure, Jacob. Happy to be here.

Jacob Wonn: All right. With that, we'll wrap up this episode of Worth It. We hope you enjoyed this podcast and please join us for future episodes. If you would like to receive notifications when new episodes are available, please visit our website, Proskauer.com, and click the 'Subscribe to our publications' link at the bottom of any page. Thank you for listening.

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