Decanting

# How to mend a broken trust

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When your grandfather's trust becomes as clunky, antiquated, and broken down as his Oldsmobile – decanting offers a much needed estate planning upgrade. For those trusts that have outlived their usefulness or original purpose, decanting is a powerful modernization tool that can breathe new life into an old trust. Decanting achieves the seemingly impossible effect of changing or modifying certain terms in an otherwise irrevocable trust.

Borrowing its name from the wine making and wine tasting process, trust decanting involves taking the assets from an old trust and, while leaving the undesirable sediment behind, pouring those assets in a new trust vessel with more favorable provisions. The purpose of decanting is to 'keep the good, and leave the bad behind.'

Many irrevocable trusts, even those created fairly recently, do not accommodate or anticipate the changing circumstances affecting trust settlors and trust beneficiaries. Furthermore, tax laws, creditor rights laws, marriage and divorce laws, and government assistance laws all change. Decanting serves as one of the most effective methods for repairing trust provisions that have become obsolete or even disadvantageous in the context of changing personal and legal circumstances.

One of the most popular reasons for decanting a trust is to extend the time in which it would ordinarily terminate. An older, prototypical trust may call for staggered distributions to a settlor's children (or grandchildren) when they reach a prescribed age. For example, upon the death of the last surviving parent, a trust may call for the creation of equal and separate shares for each living child. From each share, one-third of its principal would be distributed outright to its child-beneficiary at age 30, one-half at age 35, and the remaining balance of each trust share would be distributed outright and free of trust when that child attains age 40.

In many cases, the age at which a trust settlor thinks their children or grandchildren can responsibly enjoy and invest their inheritances gets older and older with time – or is never reached. If an unprepared child inherits significant wealth at a relatively young age, there is a good chance that the wealth is squandered. Prolonging the term of trust through decanting can certainly help ensure there is capital to sustain a beneficiary's retirement, as well as preserving assets to pass to a beneficiary's children.

**Before examining how trust decanting is accomplished, let's consider some of the many reasons behind decanting.**

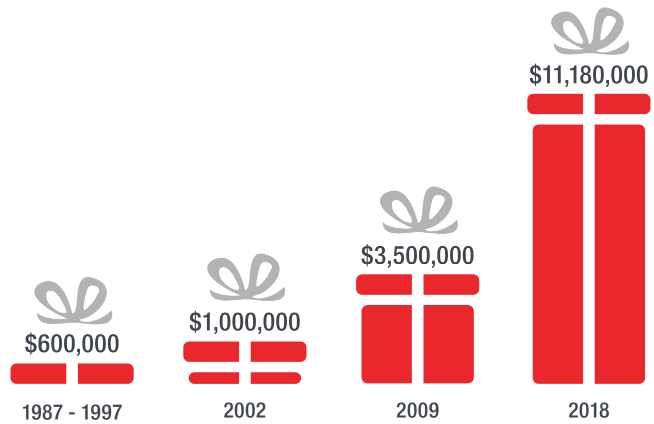
If the original intent of the trust's settlor is to retain family wealth within family bloodlines, that purpose is frustrated if a child or beneficiary is facing a potential divorce, a lawsuit, creditor issues or a personal bankruptcy. Once assets are distributed out of a trust to a beneficiary, they can be attached and liquidated by a judgment creditor.

Consider also a trust beneficiary with special needs, particularly those born after a trust's creation or those who develop a disability after trust funding. Distributions from a trust to a beneficiary with special needs may disqualify him or her from certain governmental assistance programs. Even trusts that utilize certain distribution standards such as "health, education, maintenance, and support," may cause a beneficiary to fail certain income and asset tests necessary for government aid qualification. Decanting a trust with these provisions to a trust with purely discretionary distribution standards, can, however, allow special needs beneficiaries to maintain their eligibility for government assistance.

> If however, the old trust is decanted to a new trust lasting for the beneficiary's entire lifetime, the trust assets are available to a beneficiary when needed, yet they remain ring-fenced from creditors and other threats outside the family bloodlines.

Another popular and powerful reason behind decanting old trusts is to optimize a trust's overall tax impact at the death of a beneficiary. Estate and gift tax laws have changed dramatically over the last generation. For instance, The Tax Cuts and Jobs Act just doubled the estate and gift tax exclusion to $11,180,000 per individual, beginning in 2018. Even fairly recently, many trusts were designed to avoid estate tax inclusion when the exclusion levels were much lower: $600,000 (1987-1997), $1,000,000 (2002) or $3,500,000 (2009).

**Estate and Gift Tax Exclusion**




Arising out of this history of increasingly more generous estate tax laws and limits, are large populations of trusts designed primarily to avoid estate tax inclusion (and estate taxes). This avoidance of estate tax inclusion applies in cases when beneficiaries like a surviving spouse and children pass away. Yet, despite the success of the stock market over the last 25 years, many individuals and couples can add up all the wealth they own either directly or indirectly – trusts included and excluded from their estates – and find that the sum falls far below the current ($11,180,000/$22,360,000) exclusions. In many cases, this is true even if the exclusion sunsets back to its $5,590,000 (plus inflation) level in 2026.

Due to these exclusion amounts that are much higher than trust settlors and trust authors ever anticipated, many beneficiaries and their families simply receive no tax benefit from a trust designed to exclude assets from their taxable estates. These outdated estate exclusion trusts are designed to avoid a tax that in today's tax environment is not otherwise due. Therefore, nothing is gained – but what is lost?

The trust is "broken," not simply because it no longer accomplishes its estate tax savings objectives. There is also a very real income tax opportunity cost associated with these trusts.

Not surprisingly, a practical solution to this problem lies in decanting. In the case of a surviving spouse beneficiary, whose all-inclusive wealth falls below the $11,180,000 threshold, they should decant the estate excluded trust to a trust that confers to her a 'general power of appointment.'

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> While those assets included in a decedent's estate at death receive a step-up in basis to fair market value, the trust assets excluded from a beneficiary's estate keep their "carryover" basis when the trust beneficiary passes away. Thus, the next-generation beneficiaries of an exclusion trust would likely owe a capital gains tax when they sell inherited assets.

The mere existence of a general power of appointment is sufficient to cause estate tax inclusion – with no adverse tax effect since the sum of all the wealth falls below the applicable exclusion amount. At the same time, estate inclusion (meaningless or otherwise) entitles the trust assets to a step-up in basis at the surviving spouse's death, allowing the children to sell appreciated assets and concentrated positions incurring little or no capital gains tax.

In Part I of this article above, we've learned that there are irrevocable trusts, and there are broken trusts, but decanting can save trusts from becoming irrevocably broken. In part two of this article, we will examine the legal requirements for decanting and the step-by-step mechanics of a real-world decanting process. We will also more closely analyze some creative and flexible uses of those 'powers of appointment' in decanted trusts to achieve the desired tax and non-tax benefits.

For more information, please contact your Key Private Bank Advisor.

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