

## Trust Remodeling

Even irrevocable trusts can be altered to suit current needs. South Dakota's new decanting law, effective July 1, 2007, provides the best tool for doing so

“Irrevocable” does not truly mean “unchangeable.” Today, trustees and beneficiaries of an irrevocable trust no longer need to blindly accept the trust’s terms but instead should consider whether the trust needs remodeling and, if so, whether a decanting statute may be the best means to do so.<sup>1</sup> Trust beneficiaries often do not realize they have this option, and assume instead that the terms of a trust of which they are beneficiaries may not be changed and must be borne. Indeed, many advisors also assume that it’s either impossible to amend an irrevocable trust or that the possible amendments are too limited in scope to merit the attempt. Nothing could be further from the truth.

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Choosing the most appropriate decanting statute depends on the nature of the trustee’s discretionary authority and whether the beneficiaries of the new trust will include contingent beneficiaries of the original trust. Today, South Dakota’s new decanting statute, effective July 1, 2007, provides the most flexibility for trust remodeling.

Trustees or beneficiaries might wish to modify an irrevocable trust to:

- improve the trust’s governance structure;
- change the law applicable to the trust when the terms of the trust do not facilitate a change to its governing law;

- change dispositive provisions;
- change the administrative terms of the trust to ensure the trust provides the proper tools to its fiduciaries for the best management of the trust; or
- modernize an outdated trust agreement.

One example would be to modify a trust to allow the appointment of an investment director who would be exclusively responsible for trust investments while shielding the trustee from liability for the director's actions. Another would be to change a trust's termination distribution provision from a *per stirpes* to a *per capita* division, if the purposes of the trust and the circumstances permit.

Historically, modification of a trust was possible through judicial action, often requiring the consent of all of the beneficiaries, or through a court-approved equitable deviation.<sup>2</sup> In addition, a trustee might, under common law, have the power to make distributions of trust property to another trust, even one created by that trustee.

The Uniform Trust Code (UTC) expands a beneficiary's and trustee's ability to amend an irrevocable trust, although some adopting states have limited this expanded authority. Twenty states have adopted some version of the UTC.

Certain jurisdictions have enacted decanting statutes that permit a trustee with discretionary distribution authority to distribute trust property into another trust with different terms, even if the language of the trust only provides for distributions "to or for the benefit of" the trust beneficiaries. New York was the first state to pass a decanting statute, followed by Alaska, Delaware, Tennessee, and, most recently, South Dakota.<sup>3</sup> These decanting statutes generally allow a trustee with discretionary distribution authority over a trust, in effect, to modify the terms and conditions upon which trust property is held for its beneficiaries. Other states, reportedly including Florida, Ohio and Pennsylvania, are considering enacting

their own decanting statutes.

Let's focus here on UTC trust modifications, common law decanting authority and decanting statutes—particularly South Dakota's recent decanting statute.

### UTC MODIFICATION

The model UTC provides various means to modify an irrevocable trust, either by consent of the settlor and all beneficiaries, by beneficiaries with court approval or by court decision alone.<sup>4</sup> Three of these methods have potentially broad application:

(1) Section 411(a) of the UTC provides for the modification of an irrevocable trust by the consent of the settlor and all of the beneficiaries, a codification of the law in many states.<sup>5</sup> No standard or trust purpose need be shown if these parties consent.

(2) UTC Section 411(b) provides for modification without the consent of the settlor, a particularly useful option for old trusts. It provides that "a noncharitable irrevocable trust may be modified upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust." Most importantly, Section 411(b) goes further and provides that a court may approve the modification even if all of the beneficiaries do not consent, as long as the modification is not inconsistent with any material purpose of the trust and the interests of any dissenting beneficiary are adequately protected.<sup>6</sup> Although a trustee has standing to object, a modification under this authority may be imposed over a trustee's objection.<sup>7</sup>

(3) The third method depends upon a demonstration of the trust purpose, a frustration of that purpose and a modification that provides a remedy. UTC Section 412(a) provides that a court may modify a trust's administrative or dispositive terms, or terminate the trust, if, because of changed or unanticipated circumstances, the modification or termination will further the trust's purposes. This is an expanded version of the common law doctrine of equi-

Decanting laws generally allow a trustee with discretionary authority to modify the terms and conditions upon which trust property is held for a beneficiary.

table deviation because it clearly allows changes not only to administrative provisions, but also to dispositive terms. The UTC's broadened version of the doctrine is similar to *Restatement (Third) of Trusts* Section 66(1), except that the restatement imposes a duty on a trustee to petition for an administrative modification or deviation if the trustee is aware of changed circumstances justifying the change.

Decanting statutes (or a common law decanting power), particularly the South Dakota statute, represent an additional means to modify a trust that may be more flexible than that provided by the UTC because decanting permits a transfer of trust assets to a new trust with different terms.

### COMMON LAW DECANTING

The core principle of the decanting statute—that a trustee with discretionary distribution authority may exercise that authority to appoint trust property in further trust rather than make an outright distribution—arguably is a codification of the common law of some states.<sup>8</sup> The existence of this trustee power under common law rests on two key principles:

(1) The *Restatement (Second) of Property* states that “a power of appointment is authority, other than as an incident of the beneficial ownership of property, to designate recipients of beneficial interests in property.”<sup>9</sup> A trustee’s discretionary power to make distributions to or for a beneficiary or a defined group of beneficiaries gives the trustee a power to designate beneficial interests. A trustee has legal title only, not beneficial ownership. Therefore, a trustee holding a discretionary power holds a special (that is to say, non-general) power of appointment over trust property.<sup>10</sup>

(2) A holder’s authority to exer-

cise a power of appointment is unlimited except to the extent the creator of the power of appointment imposes limits.<sup>11</sup> This principle also applies to non-general powers of appointment.<sup>12</sup> In other words, the holder of a power of appointment, general or otherwise, may exercise the power to make a distribution of property either outright or in further trust, unless the powers are expressly limited in the trust document.<sup>13</sup>

Although there is support in decided cases for this position, it can be difficult to demonstrate that

**Of course, public policy dictates that there be some limitations on a trustee’s ability to revise a trust, so decanting statutes have restrictions.**

this is a particular jurisdiction’s common law (especially if dealing with an older trust and the historic law of the jurisdiction.) Therefore, a clear grant of authority under a state statute is preferable.

### STATUTES

Decanting statutes allow a trustee with discretionary distribution authority over a trust, in effect, to modify the terms and conditions upon which trust property is held for its beneficiaries. For example, a trustee may decant trust property to a new trust with more (or less) restrictive dispositive provisions, a different line-up of successor fiduciaries or different investment objectives. Typically, neither settlor nor beneficiary consent is required

for a trustee to exercise its authority under a decanting statute.

Public policy dictates that there should be some limitations on a trustee’s ability to revise a trust in this manner, of course, so decanting statutes typically impose limits on: (1) who may be a beneficiary of the new trust and (2) when the grant of distribution authority to a trustee is sufficiently discretionary to enable that trustee to take advantage of the statute. Delaware’s statute, for instance, requires that the new trust have as its beneficiaries only persons who are “proper objects” of the exercise of the trustee’s power.<sup>14</sup> In other words, beneficiaries of the new trust must be, under Delaware law, only those persons who were beneficiaries of the old trust and for whose benefit the trustee of the old trust had discretionary authority to make distributions. Based on experience to date with the Delaware statute, this limitation tends to restrict the decanting process to trust restructurings where beneficial interests are not changed at all, though the statutory language is not so restrictive. Tennessee’s statute is similar to Delaware’s. New York requires that, in order for the statute to apply, a trustee’s discretion to make distributions must be “absolute.”<sup>15</sup> Alaska’s decanting statute, until the 2006 revisions were made to it, likewise required that the trustee’s discretion be “absolute;” it now permits decanting even where the trustee’s discretionary authority to distribute is limited by a standard.<sup>16</sup> Neither Delaware’s nor Tennessee’s statute requires that a trustee’s discretion to make distributions be absolute.

### SOUTH DAKOTA

South Dakota’s new decanting statute allows for even broader author-

ity for modification of a trust than other states' decanting statutes. South Dakota requires only that a trustee have "discretionary authority" (without requiring that authority to be "unfettered" or "absolute.") Also, South Dakota's list of acceptable beneficiaries of the new trust is worded in the disjunctive. The beneficiaries of the new trust have to be either: (1) "proper objects" of the exercise of the distribution power or (2) "one or more of those other beneficiaries of the first trust to or for whom a distribution of income or principal may have been made in the future from the first trust at a time or upon a happening of an event specified under the first trust."<sup>17</sup>

The second category provides that the new trust's beneficiaries—even primary beneficiaries—need not be proper objects of the exercise of the discretionary power; they can instead be persons who are merely contingent beneficiaries of the old trust. In other words, the language of the South Dakota statute would permit the new trusts into which old trusts are decanted to have different beneficial interests. It would even allow formerly contingent beneficiaries to become current beneficiaries and share equally (or pursuant to a different allocation) with those beneficiaries who previously were the only current beneficiaries.

However, the South Dakota statute restricts a trustee's exercise of the decanting authority in that he must take into account the purposes of the trust from which property is to be decanted, the terms of the new trust and the consequences of the decanting.<sup>18</sup>

The text of the key provisions of South Dakota's new decanting statute is instructive. Section 1 states: "Unless the terms of the instrument expressly provide otherwise, a trustee who has discretionary authority, under the terms of a testamentary instrument or

irrevocable *inter vivos* trust agreement, to make a distribution of income or principal to, or for the benefit of, one or more beneficiaries of a trust (the 'first trust'), may instead exercise such authority by appointing all or part of the income or principal subject to the power in favor of a trustee of a trust (the 'second trust') under an instrument other than that under which the power to distribute is created or under the same instrument, in the event that the trustee of the first trust decides that the appointment is necessary or desirable after taking into account the purposes of the first trust, the terms and conditions of the second trust, and the consequences of the distribution. However, the following apply:

"(1) The second trust has as beneficiaries only one or more of those beneficiaries of the first trust to or for whom a discretionary distribution may be made from the first trust and who are proper objects of the exercise of the power, or one or more of those other beneficiaries of the first trust to or for whom a distribution of income or principal may have been made in the future from the first trust at a time or upon the happening of an event specified under the first trust."

The statute raises an issue as to whether a trust's purposes are sufficient to support a decanting.

Because South Dakota's decanting statute is very new, its language has not been applied by the courts. The statute uses the bare "purposes" term, without a modifier such as "material purposes" or "primary purposes." In considering how a decanting serves the trust's purposes, should the trustee consider a trust's purposes collectively, in a big-picture approach, or differentiate between material purposes and lesser purposes, or look to each trust purpose?

Logic dictates that insignificant, ancillary purposes of a trust should not thwart greater trust purposes if the latter are best served through a decanting. Moreover, in considering whether to decant a trust

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and whether the trust's purposes support any modification of the terms of the original trust, a trustee could be guided by a court's analysis of the purposes of a trust when considering whether to grant an equitable deviation from the trust's terms. Under common law equity jurisdiction, and in some states under statutory law (including the UTC), the doctrine of equitable deviation permits a court to confer a power on a trustee in an attempt to prevent the failure or substantial impairment of the purpose for which the settlor created a trust.<sup>19</sup>

Under this doctrine, as stated in the comments to UTC Section 412, the purpose "is not to disregard the settlor's intent but to modify inopportune details to effectuate better the settlor's broader purposes." In *Matter of Pulitzer*, the court relied on this doctrine to permit the trustees of a trust holding shares of a company that published a newspaper to approve a sale of the company despite a prohibition on such sale, because it appeared that the company would soon have no value.<sup>20</sup> In another case, a testator established a trust for his grandson's education, but stipulated that no distribution be made to the grandson after Dec. 31, 1945. The grandson subsequently was inducted into the armed forces after one year at school. The court approved a deviation that permitted the trust to make distributions to the grandson to complete his education after his return in 1946.<sup>21</sup> Courts also have relied upon the doctrine of equitable deviation to deal with other investment restrictions and to otherwise permit a trustee to deviate from the terms of a trust due to the exigencies of the situation.<sup>22</sup>

By analogy, a trustee could consider a decanting as a means to modify the terms under which trust property is held in order to avoid a

frustration of the settlor's primary purposes. In this way, a decanting power becomes a much more practical solution to dealing with problems for which equity demands a modification of the trust's terms, rather than requiring a trustee to petition a court under the equitable deviation doctrine for any and all modifications. Generally, if a modification is not a radical one, trustees should be willing to use the decanting statute to modify a trust's terms without seeking beneficiary consent or court approval. In considering a radical modification, a trustee likely would wish to seek some protection from liability either by obtaining beneficiary consent or court approval to exercise the decanting power (even though neither the consent nor the approval is required under the decanting statute.)

We do not know for certain if the courts will defer to a trustee's determination that the trust's purposes are furthered by the decanting, or if the courts will make an independent determination. Yet, the courts should defer to the trustee's judgment on this question, as the statute's language does not invite judicial review. It merely provides that trustees may act if they take certain things into account. It does not specify that the trustees may act only if certain things are true. If the statute had provided that the trustee's decanting must be consistent with the purposes of the trust, that would invite a court's involvement in the determination of whether the decanting was, in fact, consistent with the trust's purposes. But the statute simply states that the trustee must take the trust's purposes into account, indicating that the trustee has discretion. In other areas of trust law, when decisions are left to a trustee's discretion, courts do not readily substitute

their judgment for that of a trustee in the exercise of that discretion, but intervene only when there has been an abuse of that discretion.<sup>23</sup> There is no reason to conclude that the standard for judicial review of a trustee's exercise of its authority to decant a trust should be different.

This distinction is important because it applies a favorable standard of review, which is clearly necessary because we will never know intentions with certainty. It is also important because a court is required to follow the rules of evidence in a judicial proceeding and typically is limited to the four corners of the document when attempting to ascertain a settlor's probable intent or purpose in establishing a trust. A trustee, on the other hand, is able to make his discretionary decisions on the basis of his reasonable investigation of the issues and upon having reasonably adequate information (within or without the trust agreement) to determine a settlor's most likely purpose(s) in establishing a trust.

Assuming a decanting is possible under the applicable state law, before electing to do so, a trustee must consider whether it will result in adverse income or transfer tax consequences.<sup>24</sup> For example, will decanting a trust cause it to lose its exemption from generation-skipping transfer tax?<sup>25</sup>

A decanting statute—especially one as broad as South Dakota's—is an incredibly flexible and useful tool. But wielding it demands caution. ■

#### Endnotes

1. "Decanting" typically refers to a pour over of funds from one trust to another, usually with different terms and usually by action of the trustee.
2. *Restatement (Third) of Trusts*, Section 66, provides that: "The court may modify an administrative or distributive provision of a trust,

- or direct or permit the trustee to deviate from an administrative or distributive provision, if because of circumstances not anticipated by the settlor the modification or deviation will further the purposes of the trust." This section presents a current interpretation of the doctrine of equitable deviation.
3. First New York, in 1991, and then Alaska (1998), Delaware (2003), Tennessee (2004) and, most recently, South Dakota (Jul. 1, 2007) enacted decanting statutes. New York Estates Powers & Trusts Law (N.Y.E.P.T.L.) 10-6.6(b); Alaska Statutes Section 13.36.157; Delaware Code Annotated 12 Section 3528; Tennessee Uniform Trust Code Section 816(b)(27); South Dakota 2007 Session Laws HB 1288.
  4. Uniform Trust Code Sections 410 through 416. In addition to the methods discussed here, the UTC provides for reformation and for modifications dealing with unecological trusts and trustee arrangements, impractical administrative terms and adjustments to achieve the settlor's tax objectives.
  5. UTC Section 411(a) provides two options, modification with or without court approval. Older versions of the UTC did not require court approval for a modification by the consent of the settlor and all the beneficiaries. However, it was amended at the request of the American College of Trust and Estate Counsel (ACTEC) to include an option requiring court approval. ACTEC's concern was that if court approval was not required, then Section 411(a) might expose irrevocable trusts in those states that previously required court approval to estate tax. See the 2004 comment to UTC Section 411(a).
  6. UTC Section 411(e).
  7. UTC Section 410(b).
  8. See *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782 (1940) (trustee used special power of appointment to distribute trust property to a new trust).
  9. *Restatement (Second) of Property* (Donative Transfers), Section 11.1 (1986).
  10. *Ibid.*, at comment d.
  11. *Restatement (Second) of Prop.* (Donative Transfers), Section 12.2 (1986).
  12. *Restatement (Second) of Prop.* (Donative Transfers), Section 19.3 (1986), including comment (a).
  13. *Ibid.*, at Reporter's Note 3; see also 94 A.L.R.3d 895, at 3a; *Scott on Trusts*, Section 17.2 (4th ed., 2001); *Restatement of Prop.*, Section 358 (if donor shows no contrary intent, special power may be exercised to appoint interests in trust for the benefit of the objects of the power). See also *Bartlett v. Sears*, 81 Conn. 34 (1908) (beneficiary's exercise of a power of appointment to direct property in further trust was valid); *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782 (1940) (see note 8); *In re Estate of Spencer*, 232 N.W.2d 491 (Iowa 1975) (special power of appointment permits exercise in favor of trust if no contrary intent of settlor).
  14. 12 Del. Code Ann., Section 3528(a)(1).
  15. N.Y.E.P.T.L. 10-6.6(b)(1).
  16. Alaska Stat. Section 13.36.157.
  17. South Dakota H.B. 1288, at Section 1(i).
  18. *Ibid.*, at Section 1's preamble.
  19. "It is permitting the trustee to do not what the settlor intended to permit him to do but what it thinks the settlor would have intended to permit if he had known of or anticipated the circumstances that have happened . . . In so doing, the court is not interpreting the terms of the trust but is permitting a deviation from them in order to carry out the purpose of the trust." *Scott on Trusts*, Section 167 (4th ed. 2001).
  20. 249 N.Y.S. 87 (1931), *aff'd mem.*, 260 N.Y.S. 975 (N.Y. App. Div. 1932).
  21. *Donnelly v. National Bank of Washington*, 27 Wash. 2d 622 (1947).
  22. See, for example, *Trust Co. of New Jersey v. Glunz*, 181 N.J. Eq. 73 (1935), *aff'd*, 121 N.J. Eq. 593 (1937) (trustee permitted to defer the sale of real property during what was a depressed real estate market, despite the trust's requiring the sale within a specific period); *Estate of Traung*, 207 Cal. App. 2d 818 (1962) (payment permitted to guardian of insane beneficiary); *Adams v. Cook*, 15 Cal. 2d 352 (1940) (voided instruction to sell land once oil was discovered and a lease determined to best maximize trust property's value).
  23. *Restatement 2d of Trusts*, Section 187 provides that "[w]here discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court except to prevent an abuse by the trustee of his discretion." See also comment e to this *Restatement* section. See also *Scott on Trusts*, Section 187. In *Firestone Tire & Rubber Co. v. Burch*, 489 U.S. 101, at 111 (1989), the Supreme Court stated that "[t]rust principles make a deferential standard of review appropriate when a trustee exercises discretionary powers" (citing the *Restatement*, as well as G. Bogert, *Law of Trusts and Trustees* Section 560 (2d rev. ed. 1980)). See also *Nichols v. Eaton*, 91 U.S. 716, at 724-725 (1875) ("When trustees are in existence, and capable of acting, a court of equity will not interfere to control them in the exercise of a discretion vested in them by the instrument under which they act.").
  24. The Internal Revenue Service may attempt to argue that a trust modification may be the equivalent of a distribution pursuant to the original trust instrument, followed by an exchange of interests among the beneficiaries, and thereby trigger a recognized gain for income tax purposes. See *Cottage Savings v. Commissioner*, 499 U.S. 554 (1991). It also is possible for a gift or disguised gift to be made in the course of a trust modification that results in a deemed gift to the trust by a new transferor, which may have gift, estate or generation-skipping transfer tax consequences.
  25. The final generation-skipping tax (GST) regulations create a safe harbor for four types of modifications, none of which will affect the grandfathered status of a trust. Treasury Regulations Section 26.2601-1(b)(4). One safe harbor applies to the exercise by a trustee of a discretionary power to distribute trust principal from a grandfathered trust to a new trust, but only if the discretionary power is either pursuant to the terms of the trust instrument or pursuant to the state law in effect at the time the trust became irrevocable. Another safe harbor applies to a modification of a grandfathered trust that does not shift a beneficial interest to a lower generation or postpone vesting. A decanting or modification that qualifies for one of these safe harbors will not cause a GST-exempt trust to lose its exempt status.