Changing the Unchangeable: Decanting an Irrevocable Trust

Key Takeaways:

- A strategy known as "decanting" could potentially allow you to alter the terms of an irrevocable trust.
- Decanting can be used to remove a beneficiary, to split up one trust into two trusts and for other reasons.
- Tax complexities and other factors make it important to get the right help when decanting a trust.

Irrevocable trusts are a cornerstone of many families' broader wealth management plan—and with good reason. Such trusts can potentially give you immediate tax benefits, reduce estate taxes down the road and protect assets from creditors.

Of course, to get such benefits, you have to give up control over the assets you place in the irrevocable trust.

But what if something changes that threatens to put an irrevocable trust in conflict with its original purpose and the trust creator's (the grantor's) intent? Maybe it's a new tax law—or perhaps there's been a major development in the life of the person for whom the trust was set up (the beneficiary). In such instances, an irrevocable trust's more rigid and "set in stone" characteristics could suddenly become a big burden and disadvantage.

The good news: It's possible that an irrevocable trust may not be as unchangeable as it seems at first glance.

A strategy known as "decanting" could potentially allow you to alter the terms of an irrevocable trust you have in place (or are about to create). Indeed, some wealthy families use this often-overlooked strategy to modify and improve their existing trusts in certain situations.

Here's a look at what it means to decant a trust—and how to decide if it's a step you might consider taking, either now or down the road.

FROM ONE TO ANOTHER

Very often, irrevocable trusts work just as their makers intended them to—in part by protecting against the risk that someone could come along after they're gone and change a trust's terms in unwanted ways. But these trusts can sometimes benefit from being altered or fixed—and that's where the concept of trust decanting comes into play.

In the world of wine, decanting involves carefully pouring wine from an old bottle into a new container or serving vessel. The purpose is to transfer the liquid while leaving the unwanted sediment that has built up in the bottle over time. The result should be a delicious-tasting glass of wine without impurities.

With trusts, the concept is virtually the same. Trust decanting aims to "pour" the assets from a trust that has become outdated (or that contains a mistake) and now goes against the trust maker's intentions into a newly created trust with improved terms—so that one or more beneficiaries get the intended benefits while avoiding the undesirable aspects of the original trust. Think of it as a sort of trust do-over.

Decanting has been done by sophisticated law firms for decades. And while it's becoming increasingly common, trust decanting isn't allowed in all states. What's more, the rules and regulations regarding decanting can vary significantly depending on the particular state and jurisdiction. So, for example, some of the strategies discussed below may be feasible in some areas of the country but not others. The best bet: Consult with a professional who has experience with decanting.

REASONS TO DECANT

There are numerous reasons you could find yourself wanting to decant an irrevocable trust you've set up. Some key drivers behind trust decanting include the following:

1. **Remove a beneficiary.** If a beneficiary of a trust has developed a drug addiction, say, or has in some way upset the grantor through words or deeds, decanting may be used in order to strip the trust of that beneficiary and replace him or her with a new one. This is one of the most common reasons people decant trusts.

2. **Combine multiple similar trusts.** Sometimes, people end up being the beneficiary of several trusts with similar terms. Decanting can merge multiple trusts into one, thereby reducing administrative costs and oversight.

3. **Split one trust into several.** Conversely, a single trust might have multiple beneficiaries with a wide variety of financial needs. That one trust can be decanted into separate trusts that are more customized to each beneficiary. For example, say a brother and sister are part of a single trust. The brother would like to invest the assets more aggressively than would the sister, who is extremely risk-averse. By separating the single trust into two through decanting, the siblings can better implement their respective investment approaches.

4. **Convert from a support trust to a discretionary trust.** Support trusts are set up to pay only for a beneficiary's education, health and similar expenses. If a trustee wants the assets to fund other purposes, the trust can (in some states) be decanted to allow for discretionary distributions. What's more, support trusts are not always protected from the claims of beneficiaries' creditors. Decanting into a discretionary trust can potentially build a wall around the trust assets.

5. **Move the trust to a different state.** Changes to state laws regarding taxation, creditor protection and other issues can negatively impact some trusts. Decanting can convert a trust that's governed by unfavorable laws into a new trust based in a different state with more favorable rules and regulations. For example, decanting might be used to avoid high income taxes in a particular state.

6. **Set up a special-needs trust.** If the beneficiary of an existing trust develops a disability or special need, the trust can be decanted into a special-needs trust that potentially allows the beneficiary to qualify for federal or state government benefits. Otherwise, access to such benefits could be jeopardized by the terms of the existing trust.

7. **Fix drafting errors or ambiguities.** Many trusts have vague language—and some even have full-on drafting mistakes that impact the terms. Decanting can potentially enable the trustee to correct those issues.

HOW TO DECANT

The process of decanting a trust can be somewhat complex, depending on the particulars. The first step is to see whether decanting is possible in the state where the trust was set up—as noted, not every state allows decanting.

If decanting is allowed under that state's laws, the trustee likely needs to contact the parties involved with the trust. (That said, the rules about who needs to be notified can vary significantly from state to state.) A new trust that addresses the reasons for the decanting is drafted. Once it's created and signed, the trustee can transfer the property from the old trust into the new one and begin administering it.

What if the trust is in a non-decanting state? In that case, check the existing trust document for any decanting language that would allow for decanting. If no such terms are present, see if the trust gives the trustee the power to change the trust situs—that is, the state in which the trust originated and whose laws govern it.

- If so, the trust can be moved to a new state that allows decanting.
- If not, see if there is a nonjudicial settlement agreement statute that can allow you to change the situs and then decant the trust under the new situs statute. You can also petition the court for a trust reformation—but that can be a costly endeavor.

Note: If you're in the process of setting up an irrevocable trust (or a revocable trust that will become irrevocable at some point in the future), consider adding trust decanting provisions in the agreement. This can potentially give the trust agreement the flexibility necessary to avoid getting courts involved if you ever want to decant the trust down the road.

WATCH OUT FOR UNWANTED TAXES

Navigating the trust decanting process takes skill and care. One big issue to consider is generating unwanted tax consequences. For example, it's best to keep the grantor who set up the trust completely uninvolved in the decanting process. If decanting doesn't change the grantor's rights and interest in the trust principal, there should be no estate tax issues for the grantor. However, the property in the trust could be included in the grantor's taxable estate if the IRS thinks the grantor is too "hands on" and controlling in the decanting process—or if the new trust gives the grantor a new power that he or she didn't have with the old trust.

CONCLUSION

By now it should be clear that decanting a trust isn't an endeavor to take on by yourself.

The rules are complex and can vary significantly from state to state. If decanting is an option you'd like to consider, consult with trusted advisors, such as wealth managers and trusts and estate attorneys, who have experience dealing with decanting trusts or who have experienced professionals on their team of experts. You may find yourself able to improve a trust to ensure it does what you want it to do.

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