Lest anyone think that decanting is like a magic lamp, granting unlimited wishes, it is important to keep two provisos in mind. The first, of course, is the need to comply with the requirements set out in the authorizing statute or trust instrument. The second is to structure the transaction so as not to run afoul of the tax code. Decanting statutes, including Nevada’s, contain safeguards that protect against some, but not all, of the possible pitfalls. This article seeks to serve as a checklist of tax issues that can help a trustee keep a dream solution from turning into a nightmare.

**Income Tax Issues**

A trustee should consider whether or not the trust will recognize gain on making a distribution of assets to the new trust. This is not a concern if both the old trust and the new trust are grantor trusts, because the grantor will continue to be treated, for income
tax purposes, as the owner of the trust assets.

However, the income tax question is more complicated for a nongrantor trust that holds assets encumbered with debt, such as an interest in a partnership with debt allocable to its partners. For example, if the old trust is a grantor trust and the new trust is a nongrantor trust, a transfer of an encumbered asset to the new trust triggers a deemed sale of the asset for the amount of the outstanding debt.¹

If both the new trust and the old trust are nongrantor trusts, then the answer to the income tax question may depend on whether the new trust constitutes a separate taxable entity. In private letter rulings, the IRS has taken the position that a decanting distribution of an entire trust to a newly created trust effectively results in a continuation of the old trust.² No gain or loss should result from such a decanting.

However, if the new trust is a separate taxpayer, which will likely be the case if the old trust distributes assets to an existing trust, there is some uncertainty as to whether the old trust can recognize gain with respect to an asset encumbered by debt in excess of its basis. It appears reasonable to assume that no gain should result, since a trust generally does not recognize gain upon distributing assets unless the trustee elects otherwise.³

However, some caution may be appropriate here, since there is little authority dealing with the distribution of encumbered property from a trust.

Sometimes decanting is used to divide a trust into separate trusts. A pro rata division of assets between the new trusts should not be a taxable event.⁴ However, if the trustee intends to make a non-pro rata allocation of assets, the trust document should be reviewed to confirm that it either permits such an allocation or effectively incorporates the statutory power set out in NRS 163.395. A severance of a trust will not result in a taxable exchange of property if either a state statute or the trust instrument authorizes the trustee to sever the trust, and any non-pro rata funding of the new separate trusts is authorized by the statute or trust instrument.⁵

Gift Tax Issues

Trustees who are not beneficiaries generally need not be concerned with making a taxable gift by reason of decanting, even if the distribution favors one or more beneficiaries to the detriment of others.⁶ However, if the trustee is also a beneficiary, whether the trustee makes a gift depends on whether the beneficiary/trustee may make distributions to himself or herself without being limited by an ascertainable standard. Absent an ascertainable standard, a decanting distribution to another trust will be deemed an exercise of a general power of appointment and a transfer of property for gift tax purposes. When an ascertainable standard exists, Nevada law contains an important safeguard prohibiting the beneficiary/trustee from exercising the decanting authority unless the new trust also contains an ascertainable standard.⁷

If a decanting reduces the value of a beneficiary’s interest in a trust, the beneficiary could be considered to make a gift if the beneficiary has the right to stop the transaction and either consents to the transaction or allows his or her rights to expire.⁸

Significantly, Nevada law does not require court approval or the consent of any beneficiary as a condition to a valid decanting. Instead, decanting is an exercise of a power of appointment in the trustee’s discretion. Consequently, no taxable gift by any beneficiary should

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result, if the terms of a decanting comply with the authorizing statute, including the preservation of a beneficiary’s outstanding withdrawal rights. Consideration should also be given to whether the decanting distribution is consistent with the trustee’s fiduciary duties. Before decanting, a trustee should address whether or not a taxable gift could result by reason of section 2514(d) of the Internal Revenue Code, commonly referred to as the Delaware Tax Trap. Under section 2514(d), a holder of a power of appointment (such as a power to decant), is treated as making a transfer of property for gift tax purposes, if the holder exercises the power by creating another power of appointment, which in turn could be exercised so as to either postpone the vesting of any interest in the property subject to the first power, or to suspend the absolute ownership of such property, for a period ascertainable without regard to the date of the creation of the first power. In other words, section 2514(d) could be triggered by a decanting, if a power of appointment in the new trust (such as the trustee’s decanting power), may be exercised to extend the trust for a new perpetuities period that does not relate back to the date of the first trust’s creation.

Fortunately, the Nevada decanting statute contains a savings clause preventing the Delaware Tax Trap from springing. Under NRS 163.556(8), which incorporates the Nevada Statutory Rule Against Perpetuities, the perpetuities period applicable to the decanting power (as well as any power of appointment created under the decanting power) is deemed to start when the original trust was funded, and it cannot be validly exercised in a manner that would start a new perpetuities period. However, to avoid any dispute on this issue, a receiving trust should include an express provision that all trusts created under that instrument will terminate based on the perpetuities termination period applicable to the original trust.

GST Issues

Many irrevocable trusts created for multiple generations are shielded from generation-skipping transfer tax, either by reason of their grandfathered status or by having GST exemption allocated to transfers to the trust. Changes to administrative powers and provisions, such as a modification of provisions relating to the appointment of trustees, will not generally cause a trust to become subject to GST tax. However, changes to dispositive provisions, including extensions of the trust, deserve careful analysis. Grandfathered GST trusts are generally exempt from GST tax, unless they are modified or added to in ways that violate safe harbors set forth in regulations. In many cases, beneficial interests in a grandfathered trust cannot be shifted to any beneficiary who occupies a lower generation, and the time for vesting any beneficial interest in the trust cannot be extended beyond the period provided for in the original trust. The full extent to which non-grandfathered GST exempt trusts may be modified through decanting is not clear. However, for planning purposes it is useful to note that the IRS has taken the position, in private letter rulings, that a change not affecting the GST status of a grandfathered GST trust should similarly not affect the exempt status of a non-grandfathered GST exempt trust.

Conclusion

A complete analysis of the tax issues often restricts the effective scope of the decanting statute. In spite of these restrictions, however, decanting can still be a flexible tool for modifying a problematic trust.

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