

# **An Overview of Trust Modification and Decanting**

Probate and Pumpernickel

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## TRADITIONAL WAYS TO AMEND IRREVOCABLE TRUSTS

- I. Sources of Trust Modification in South Carolina Trust Code (Title 62, Article 7 of South Carolina Code of Laws) ("Trust Code")
  - a. The primary source of law addressing trust modification is found in Part 4 of the Trust Code: Creation, Validity, Modification, and Termination of Trusts.
  - b. Other ways to modify a trust were added with the 2014 Trust Code revisions:
    - i. Part 9 of the Trust Code (South Carolina Uniform Principal and Income Act); and
    - ii. Section 62-7-816A of the Trust Code (Decanting).
- II. Modification or termination of trust; proceedings for approval or disapproval – S.C. Code § 62-7-410.
  - a. This section covers who may bring an action to modify a trust.
  - b. In general, a proceeding under Part 4 may be brought by a Trustee or beneficiary.
  - c. The Settlor may also bring an action for modification with beneficiary consent, and may bring an action to modify a charitable trust under S.C. Code § 62-7-413.
  - d. South Carolina Attorney General may also maintain a proceeding to modify a charitable trust under § 62-7-413.
- III. Unanticipated circumstances or inability to administer trust effectively – S.C. Code § 62-7-412.
  - a. Court involvement is required to modify or terminate a trust due to unanticipated circumstances or inability to effectively administer the trust.
  - b. The court may modify administrative or dispositive terms, or terminate the trust if:
    - i. Circumstances arise that were not anticipated by Settlor when the trust was formed (such circumstances may have been in existence at the time the trust was created, so long as the Settlor was not aware of their existence);
    - ii. The modification or termination will further the purposes of the trust; and

- iii. The change must be made in accordance with settlor's probable intent.
- c. The court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be:
  - i. Impracticable;
  - ii. Wasteful; or
  - iii. Impair the trust's administration.
- d. Note, modification of the administrative terms of a trust does not require the court to consider the purpose of the trust of the settlor's intent.
- e. Modification under this section, because it does not require beneficiary action, is not precluded by a spendthrift provision.
- f. If terminated, the trust is to be distributed as ordered by the court.

#### IV. Uneconomic trust – S.C. Code § 62-7-414.

- a. Two routes are available for the termination or modification of an uneconomic trust – one route provides for termination of an uneconomic trust without court involvement, the other is for termination or modification of an uneconomic trust with court involvement.
- b. Termination of a Trust Without Court Involvement
  - i. In order to terminate an uneconomic trust without court involvement, the value of the trust property must be less than \$100,000. S.C. Code § 62-7-414(a); and
  - ii. The value of the trust property must be insufficient to justify the cost of administration. S.C. Code § 62-7-414(a). Note that this requirement is in addition to the \$100,000 limitation.
  - iii. Termination of an uneconomic trust pursuant to S.C. Code § 62-7-414 is initiated by the Trustee.
  - iv. Termination requires notice to the qualified beneficiaries, but does not require consent of such beneficiaries, nor does termination require court approval.

1. Qualified beneficiary means a living beneficiary who, on the date the qualification is determined (S.C. Code § 62-7-103(12)):
  - a. Is a distributee or permissible distributee of trust income or principal;
  - b. Would be a distributee or permissible distributee of trust income or principal if the interests in (a) above terminated but the termination of those interests would not cause the trust to terminate; or
  - c. Would be a distributee or permissible distributee of trust income or principal if the trust is terminated.
- v. Upon termination of an uneconomic trust without court approval, the trust property should be distributed in a manner consistent with the purposes of the trust. Often this is to the qualified beneficiaries in proportion to the actuarial value of their interests.

c. Modification or Termination With Court Involvement

- i. A court may modify, terminate, or remove a Trustee and appoint a new Trustee if the value of trust property is insufficient to justify cost of administration.
  - ii. There is no limit as to the value of the trust property if the court is involved.
  - iii. Upon termination of an uneconomic trust with court approval, the trust property should be distributed as ordered by the court, or if the court does not specify, then in a manner consistent with the purposes of the trust (i.e., to the qualified beneficiaries in proportion to the actuarial value of their interests).
- d. This section does not apply to an easement for conservation or preservation.
- e. This provides a default rule for the termination of uneconomic trusts and settlors are free to modify this rule. For example, a settlor may increase or decrease the \$100,000 limit for termination without court approval.
- f. A court may modify or terminate a trust pursuant to its authority in this section even if the settlor has forbidden it.

g. If the Trustee is also a beneficiary, the Trustee's power is limited by S.C. Code § 62-7-814.

h. Modification or termination pursuant to this section is not precluded by a spendthrift provision.

V. Reformation to correct mistakes – S.C. Code § 62-7-415.

a. A court may amend a trust to conform the terms of the trust to the settlor's intention.

b. Reformation is allowed even if terms of the trust are unambiguous.

c. Requires proof by clear and convincing evidence of the settlor's intent and that the terms of the trust were affected by a mistake of fact or law.

d. Parol evidence is allowed to show settlor's intent, even when contradictory to the plain meaning of the trust language.

e. The court may correct a mistake of fact or law in expression or inducement.

i. A mistake in expression is: (1) a failure to include a term that was intended to be included; or (2) including a term intended to be excluded. A scrivener's error is a mistake in expression.

ii. A mistake in inducement is when terms correctly reflect what the settlor wanted, but the intention was based on a mistake.

VI. Modification to achieve settlor's tax objectives – S.C. Code § 62-7-416.

a. The court may modify the terms of a trust to achieve the settlor's tax objectives, so long as such modification is not contrary to the settlor's probable intention.

b. If a beneficiary objects, then that beneficiary's interest shall not be negated, regardless of the tax benefit desired.

c. The court may provide that the modification has retroactive effect.

d. Federal law determines whether modifications will be recognized for federal income tax purposes.

- i. In general, binding recognition is normally given only to modifications made prior to the taxing event (i.e. the death of the settlor).
- ii. Federal law arguably recognizes the following modifications:
  1. Revision of split-interest trusts to qualify for the charitable deduction;
  2. Modification of trust for non-citizen spouse to become eligible as a qualified domestic trust; and
  3. Splitting of a trust to utilize better the exemption from GST.

VII. Equitable Deviation – S.C. Code § 62-7-413.

- a. Equitable Deviation is applicable only to charitable trusts.
- b. Modification of a charitable trust is available if the charitable purpose of the trust becomes unlawful, impracticable, impossible to achieve, or wasteful.
- c. Consequences of equitable deviation:
  - i. The trust does not fail in whole or in part.
  - ii. Trust property does not revert back to the settlor or his successor.
  - iii. The court may deviate from the terms of the trust to modify or terminate the trust by directing the trust property be distributed in a manner consistent with the settlor's charitable intent.
- d. A provision in the terms of a charitable trust that would result in distribution of the trust property to a noncharitable beneficiary prevails over the power of the court to modify or terminate the trust only if, when the provision takes effect, one of the following two situations occur:
  - i. The trust property is to be distributed to the settlor and the settlor is still living; or
  - ii. The rule against perpetuities is not violated.

VIII. Modification or Termination by Consent with Court approval – S.C. Code § 62-7-411

- a. There are two routes to take when attempting to modify or terminate a trust under this section; however, both require court approval.
- b. With Settlor's Consent:
  - i. Requires consent of settlor and all beneficiaries. Note: not only qualified beneficiaries.
    1. The definition of "beneficiary" means a person that:
      - a. has a present or future beneficial interest in a trust, vested or contingent;
      - b. in a capacity other than that of Trustee, holds a power of appointment over trust property; or
      - c. in the case of a charitable trust, has the authority to enforce the terms of the Trust.
    2. Some modification sections require action of the beneficiary, while others require action of a qualified beneficiary.
  - ii. The modification or termination may be inconsistent with a material purpose of the trust.
  - iii. An agent, conservator, or guardian may consent on settlor's behalf (subject to certain local law limitations).
  - iv. Settlor's consent not deemed to be the exercise of a taxable power.
  - v. No gift tax consequences provided beneficiaries agree to distribute in accordance with the value of their proportionate interests.
- c. Without Settlor's Consent:
  - i. Consent of all beneficiaries required.
  - ii. The beneficiaries may modify any term of the trust if the modification is not inconsistent with a material purpose of the trust.
  - iii. Court must conclude that the continuance of the trust is not necessary to achieve any material purpose of the trust.

- d. Material purposes are not readily to be inferred. In order to be material, the purpose remaining to be performed must be of some significance. A finding of such a purpose generally requires some showing of a particular concern or objective on the part of the settlor, such as concern with regard to the beneficiary's management skills, judgment, or level of maturity.
- e. Trustee must distribute the assets as ordered by the court. Note that Trustee involvement is otherwise not necessary.
- f. If not all of the beneficiaries consent (to either the modification or termination), the modification or termination may be approved if the court is satisfied:
  - i. If all of the beneficiaries had consented, the trust could have been modified or terminated under this section.
  - ii. The interests of those beneficiaries who did not consent will be adequately protected. This provision is useful because ALL beneficiary consent must be obtained, and this section allows the court to modify or terminate the trust if all beneficiaries cannot be located, or are non-responsive for a request to consent to the change.
- g. Beneficiaries cannot terminate a spendthrift trust if the purpose of the trust is to provide income for life or until the trust fund is exhausted.

IX. Combination and Division – S.C. Code § 62-7-417

- a. A Trustee, after notice to (not consent of) the qualified beneficiaries, can combine or divide a trust.
- b. No court approval is required.
- c. The division or combination must neither:
  - i. impair the rights of any beneficiary; nor
  - ii. adversely affect achievement of the purposes of the trust.
- d. It is common to divide a trust to maximize an exemption, like the GST exemption.
- e. Given the substantial tax benefits often involved, failure to divide a trust could be a breach of fiduciary duty by a Trustee.

- X. South Carolina Uniform Principal and Income Act – S.C. Code § 62-7-901 et seq.
  - a. Adjustments between principal and income – S.C. Code § 62-7-904
    - i. This portion of Part 9 of the Trust Code is not a new provision.
    - ii. A Trustee may adjust between principal and income to the extent the Trustee considers necessary as a prudent investor after considering the following:
      - 1. Nature, purpose, and duration of the trust;
      - 2. Settlor's intent;
      - 3. Beneficiaries' circumstances;
      - 4. Liquidity vs. preservation of capital;
      - 5. Decrease in value of principal;
      - 6. Whether trust explicitly disallows power to adjust;
      - 7. Overall economic effect (i.e. whether assets anticipated to appreciate or depreciate in value); and
      - 8. Tax consequences.
    - iii. A Trustee may not adjust in certain circumstances listed at S.C. Code § 62-7-904(C). These limitations are to preserve tax benefits important at the time of the creation of the trust and to prevent adverse tax consequences. This is a savings clause built into the statute.
    - iv. A Trustee may not:
      - 1. Adjust certain mandatory income streams distributable to a surviving spouse, if an estate or gift tax marital deduction was allowed;
      - 2. Change a fixed income amount to a beneficiary (like a unitrust amount);
      - 3. Change an amount permanently set aside for charitable purposes;

4. Adjust if the adjustment would cause an individual to be treated as the owner of a trust for income tax purposes or for estate tax inclusion;
  5. Adjust if the Trustee is a beneficiary; or
  6. Adjust if the change would directly or indirectly benefit a Trustee.
- b. Conversion to a Unitrust – S.C. Code § 62-7-904B, et seq. (added in 2014)
- i. In lieu of exercising the power to adjust between income and principal, the Trustee may convert the trust to a unitrust, in which case the unitrust amount becomes the amount distributable.
  - ii. A unitrust provides that the income beneficiary, instead of receiving the income from the trust, receives a set percentage of the net asset value of the trust determined annually.
  - iii. A percentage between 3% and 5% does not require court approval and is presumed to treat the principal beneficiaries and income beneficiaries impartially.
  - iv. A non-interested Trustee, as provided under S.C. Code § 62-7-904C(A), has the power to:
    1. convert an income trust to a total return unitrust;
    2. reconvert a total return unitrust to an income trust; or
    3. change the percentage used to calculate the unitrust amount or to determine the fair market value of the trust assets, if certain other requirements are met:
      - a. Trustee adopts written policy for the trust outlining the changes;
      - b. Trustee gives notice to the qualified beneficiaries and the settlor (if living);
      - c. There is at least one qualified beneficiary who is not under a legal disability; and
      - d. No person receiving notice objects to the proposed action within 90 days.

- v. An interested Trustee (as provided under S.C. Code § 62-7-904C(B)) has the power to:
1. convert an income trust to a total return unitrust;
  2. reconvert a total return unitrust to an income trust; or
  3. change the percentage used to calculate the unitrust amount or to determine the fair market value of the trust assets, if:
    - a. The additional requirements for a non-interested Trustee are met; and
    - b. Trustee appoints a disinterested person who determines:
      - i. Percentage to calculate unitrust amount;
      - ii. Method to be used in determining fair market value; and
      - iii. Which assets, if any, are to be excluded in determining unitrust amount.
- vi. An interested Trustee, as defined under S.C. Code § 62-7-904B(6), is:
1. An individual Trustee who is a qualified beneficiary;
  2. An individual Trustee whose legal obligation to support a beneficiary may be satisfied by distributions of income and principal of the trust; or
  3. A Trustee who may be removed and replaced by an interested distributee. An interested distributee, as defined under S.C. Code § 62-7-904B(5), is:
    - a. a living beneficiary who is a current distributee or current permissible distributee of trust income or principal;
    - b. who has the power to remove the existing Trustee; and
    - c. designate as a successor Trustee a person who may be a related or subordinate party with respect to that distributee.

- vii. Qualified beneficiaries may request a conversion, and if the Trustee objects, may seek court action to convert.
- viii. However, a failure to convert is not considered a breach of fiduciary duty.
- ix. Applies to all trusts in existence on, or created after January 1, 2014 unless:
  - 1. The trust contains a provision clearly expressing the settlor's intention that the current beneficiary or beneficiaries are to receive an amount other than a reasonable current return from the trust; or
  - 2. The trust expressly prohibits conversion to a unitrust, or expressly states the settlor's intent that net income not be calculated as a unitrust amount.
  - 3. Note that S.C. Code § 62-2-207(c)(3) provides that despite any restrictions in the trust document, a surviving spouse who has made an elective share claim and is charged with receiving the value of the trust, always has the ability to require a conversion to a unitrust (note; however, that this section does not provide for a conversion from a unitrust to an income trust).
- x. Cannot convert certain charitable lead or charitable remainder trusts, GRATs, GRUTs, or QPRTs. In general, one cannot convert a trust where the settlor retains certain use of the trust estate assets.

## XI. Summary

- a. No court involvement is necessary for the following methods of trust modification:
  - i. Uneconomic trust termination where trust assets total less than \$100,000 – S.C. Code § 62-7-414;
  - ii. Combination and division of trusts – S.C. Code § 62-7-417;
  - iii. Adjustments between principal and income. – S.C. Code § 62-7-904; and
  - iv. Conversion to a unitrust. – S.C. Code § 62-7-904B, et seq.
- b. Court involvement is necessary for the following methods of trust modification:
  - i. Modification due to unanticipated circumstances or inability to administer trust effectively – S.C. Code § 62-7-412;
  - ii. Uneconomic trust modification or termination where trust assets exceed \$100,000 – S.C. Code § 62-7-414;
  - iii. Reformation to correct mistakes – S.C. Code § 62-7-415;
  - iv. Modification to achieve settlor's tax objectives – S.C. Code § 62-7-416;
  - v. Equitable Deviation – S.C. Code § 62-7-413; and
  - vi. Consent with court approval – S.C. Code § 62-7-411.
- c. No beneficiary consent is needed for the following methods of trust modification:
  - i. Modification due to unanticipated circumstances or inability to administer trust effectively – S.C. Code § 62-7-412;
  - ii. Uneconomic trust modification or termination – S.C. Code § 62-7-414;
  - iii. Modification to achieve settlor's tax objectives – S.C. Code § 62-7-416;
  - iv. Adjustments between principal and income. – S.C. Code § 62-7-904; and
  - v. Conversion to a Unitrust. – S.C. Code § 62-7-904B, et seq.

# DECANTING

## II. Origins of Decanting

- a. Decanting is the distribution of income or principal from one trust ("original trust") to another trust ("second trust").
- b. Basis for Decanting—A Trustee who has the discretionary power to distribute principal to a beneficiary, also has the authority to distribute principal to a trust for the benefit of such beneficiary.
- c. The Restatement (Second) of Property characterizes the authority to decant in the nature of a special power of appointment exercisable in a fiduciary capacity. South Carolina law follows this approach as well. *See* S.C. Code § 62-7-816A(f)(1).
- d. Florida Common Law—*Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940)
  - i. *Phipps* is the earliest reported case of decanting. This case was based on a Trustee's common law ability to distribute property in further trust.
  - ii. In *Phipps* the Trustee had "sole and absolute discretion" to make distributions.
  - iii. "The power vested in a Trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent."
- e. The common law of all states may allow decanting. The new South Carolina statute authorizing decanting leaves open the possibility that common law prior to the statute's enactment may have authorized a Trustee to distribute in further trust. *See* S.C. Code § 62-7-816A(h).

## III. Benefits of Decanting

- a. Changing the Administrative Provisions of the Original Trust:
  - i. Changing the governing law.
  - ii. Changing the provisions related to successor Trustees.

- iii. Adjusting Trustee compensation.
- iv. Combining trusts which otherwise would not be eligible for combination.
- v. Removing restrictions on types of investments and affiliated investments.

b. Changing the Dispositive Provisions of the Original Trust:

- i. Dividing pot trusts.
- ii. Eliminating beneficiaries.
- iii. Changing outright distributions to downstream beneficiaries to distributions in further trust (including special needs trusts).
- iv. Removing mandatory income distributions.
- v. Creating special needs trusts under some circumstances.
- vi. Making trust interests spendthrift.
- vii. Adding powers of appointment (including general powers of appointment and determined portion powers of appointment).

c. Correction of Errors

d. Tax Reasons:

- i. Moving trust situs to a state that does not tax based on the Trustee's or the Grantor's residence.
- ii. Converting from grantor trust to non-grantor trust status.
- iii. Removing all income provisions of bypass or GST trusts.
- iv. Adding a general power of appointment.

IV. Decanting under the new South Carolina statute (S.C. Code § 62-7-816A)

a. The Ability to Decant

- i. In general, the ability to decant is broad with very few restrictions.

- ii. The terms of the original trust cannot prohibit decanting. S.C. Code § 62-816A(a).
- iii. No court approval is required unless the trust expressly prohibits decanting. S.C. Code § 62-7-816A(a). If the terms of the original trust expressly prohibit decanting, court approval may be granted pursuant to the provisions of S.C. Code § 62-7-816A(a).
- iv. The Trustee must have discretion to make principal or income distributions for the benefit of one or more beneficiaries. Only the property subject to the Trustee's discretion can be decanted (for example, if the Trustee has discretion over only income, only income may be distributed to the second trust). S.C. Code § 62-7-816A(a).
- v. There need not be a current need to distribute under the standard applicable to discretionary distributions (such as distributions to a beneficiary for health, support, maintenance and education). S.C. Code § 62-7-816A(b). Comments make clear that effective administration can be the only purpose.

b. Restrictions on the Ability to Decant

- i. The Trustee may not decant if the Trustee is a beneficiary of the original trust; however, the remaining “independent” Trustees may act or the court may appoint a special fiduciary if no "independent" Trustee is available. S.C. Code § 62-7-816A(e). This prevents the decanting from being treated as a gift by the Trustee to the second trust (discussed below).
- ii. Decanting is not prohibited by a spendthrift provision or by a provision that prohibits amendment or revocation of the original trust. S.C. Code § 62-7-816A(f)(3).

c. The Terms of Second Trust

- i. The second trust may be created under a different (or the same) trust instrument. S.C. Code § 62-7-816A(c).
- ii. The Trustees of the original trust and second trust may vary or may be the same. S.C. Code § 62-7-816A(c).
- iii. The second trust cannot add a beneficiary who was not beneficiary of the original trust. S.C. Code § 62-7-816A(d)(1). However, a power of

appointment may be helpful in adding a beneficiary. S.C. Code § 62-7-816A(d)(7).

- iv. The second trust can omit beneficiaries who were beneficiaries of the original trust (subject to S.C. Code § 62-7-816A(d)(6) discussed below). S.C. Code § 62-7-816A(a).
- v. The second trust cannot accelerate a beneficiary's interest (convert a remainder beneficiary to a current beneficiary). S.C. Code § 62-7-816A(d)(2).
- vi. The second trust cannot reduce any fixed income, annuity or unitrust interest if such reduction (or inclusion of an additional provision) would cause the loss of certain tax deductions. S.C. Code § 62-7-816A(d)(3). Further, the second trust cannot reduce a qualified interest under I.R.C § 2702.
  1. Note that the reduction of a qualified interest under I.R.C. § 2702 cannot be reduced regardless of the tax consequences.
  2. A qualified interest includes a qualified annuity interest, a qualified unitrust interest or a qualified remainder interest (a non-contingent remainder in which all other interests in the trust are qualified annuity interests or qualified unitrust interests). I.R.C. § 2702(b).
- vii. If contributions to the original trust were excluded from the gift tax by the operation of I.R.C. §§ 2503(b) *and* 2503(c), then the second trust must provide that the beneficiary's remainder interest in such contributions shall vest and become distributable no later than the date which the interest would have vested and become distributable under the terms of the original trust. S.C. Code § 62-7-816A(d)(4).
  1. I.R.C. § 2503(c) provides that no part of a gift to an individual who is under age 21 shall be considered a gift of a future interest (thereby qualifying the gift for the annual exclusion) to the extent it may be expended on the minors behalf before age 21 and will, to the extent not so expended, be distributed outright to the minor upon turning age 21, or if he shall sooner die, to his estate.
  2. I.R.C. § 2503(c) is meant to qualify certain "vested" trusts for the annual exclusion.

3. S.C. Code § 62-7-816A(d)(4) prohibits the extension of the time for vesting through the use of decanting. This is meant to prevent an argument by the Internal Revenue Service that gifts to the original trust do not qualify for the annual exclusion because there is a possibility (if the original trust is decanted) that the contributions may not vest at age 21.
- viii. The second trust must provide identical withdrawal powers as the original trust. S.C. Code § 62-7-816A(d)(5).
    1. Alternatively, sufficient property must remain in the original trust to satisfy the outstanding withdrawal powers.
    2. This could affect a Crummey power or a "5 and 5" power.
  - ix. If distributions from the original trust are subject to an ascertainable standard, distributions from the second trust must be subject to the same ascertainable standard and must be exercisable in favor of the same beneficiaries. S.C. Code § 62-7-816A(d)(6).
  - x. The terms of the second trust may give beneficiaries a power of appointment which may be exercised in favor of any individual (not only in favor of those individuals in whose favor a power of appointment could be exercised under the original trust). S.C. Code § 62-7-816A(d)(7).
    1. The power of appointment may only be conferred upon a beneficiary of the original trust to whom or whose benefit the Trustee has the power to distribute principal or income of the original trust; however, the power of appointment may be exercised in favor of anyone.
    2. This provisions could trigger the Delaware Tax Trap (as discussed below).
  - xi. The terms of the original trust may modify any of these restrictions. S.C. Code § 62-7-816A(h).
- d. The Nature of the Transaction
- i. Decanting is considered the exercise of a power of appointment, other than a power to appoint to the Trustee, the Trustee's creditors, the Trustee's estate or the creditors of the Trustee's estate. S.C. Code § 62-7-816A(f)(1).

- ii. Decanting does not result in the Trustee of the original trust being considered the settlor of the second trust. S.C. Code § 62-7-816A(f)(2).

e. Procedure for Decanting

- i. The decanting must be made in an instrument in writing, signed and acknowledged by the Trustee of the original trust. S.C. Code § 62-7-816A(g)(1).
- ii. The writing must set forth the manner of the exercise of the power, the terms of the second trust and the effective date. S.C. Code § 62-7-816A(g)(1).
- iii. The writing must be kept with the records of the original trust. S.C. Code § 62-7-816A(g)(1).
- iv. Notice. S.C. Code § 62-7-816A(g)(2).
  - 1. The Trustee must give written notice to all "qualified beneficiaries" of the original trust. Qualified beneficiary means a living beneficiary who, on the date the qualification is determined:
    - a. Is a distributee or permissible distributee of trust income or principal;
    - b. Would be a distributee or permissible distributee of trust income or principal if the interests in (a) above terminated but the termination of those interests would not cause the trust to terminate; or
    - c. Would be a distributee or permissible distributee of trust income or principal if the trust is terminated. S.C. Code § 62-7-103(12).
  - 2. The notice must be given 90 days prior to the effective date of the exercise of the power to decant.
  - 3. The notice must include a copy of the written instrument described in S.C. Code § 62-7-816A(g)(1).
  - 4. Notice can be waived by written instrument signed by the beneficiary and delivered to the Trustee of the original trust. If notice is waived

by all qualified beneficiaries, the Trustee may proceed with the decanting, notwithstanding the effective date described in the notice.

5. The notice provision of S.C. Code § 62-7-109 apply. S.C. Code § 62-7-816A(j).
  - a. ". . . Reasonably suitable under the circumstances and likely to result in receipt of the notice or document."
  - b. Permissible Methods: First-class mail, personal delivery, delivery to the person's last known place of residence or place of business, or a properly directed electronic message.
6. The terms of the original trust may modify or waive the notice requirements. S.C. Code § 62-7-816A(h).

f. Other Applicable Provisions

- i. There is no duty to decant. S.C. Code § 62-7-816(A)(h).
- ii. The new statute does not affect the authority to decant pursuant to the terms of the original trust or pursuant to common law. S.C. Code § 62-7-816A(h).
  1. The reporter's comments state "Subsections (b) and (c) affirm the broad decanting authority intended to be afforded to Trustees to eliminate the uncertainty that was faced by Trustees exercising decanting authority in reliance solely on common law principles."
  2. This comment seems to imply that decanting is and was authorized by common law.
  3. This could be an important provision given the GST consequences if decanting is not authorized (by statute, the terms of the trust, or common law) at the time the first trust became irrevocable.
- iii. A court proceeding may be commenced to approve or disapprove a decanting. S.C. Code § 62-7-816A(i).

## V. Tax Implications of Decanting

### a. Income Tax Consequences to the Original Trust

- i. Decanting assets from one trust to another should not result in a realization event for the original trust for several reasons:
  1. The original trust and second trust are treated as the same trust for income tax purposes (*See* PLR 200736002).
  2. I.R.C. § 643(e) provides that assets received in a distribution from a trust receive a carry-over basis in the hands of the recipient, adjusted for gain or loss on the distribution. I.R.C. § 643(e)(3) allows an *election* to recognize gain on the distribution.
- ii. Alternative #1 above is the favored alternative (*see* PLR 200607015) and most commentators agree that the second trust should continue to use the same Employer Identification Number as the original trust.
- iii. Caveat – negative basis assets (assets subject to debt in excess of basis or a partnership interest with a negative capital account).
  1. *Crane v. Comm'r*, 331 U.S. 1 (1947) held that when a transferee assumes a transferor's liability, the amount realized under I.R.C. § 1001 includes the amount of the liability assumed by the transferee. From this it appears that income will result to the beneficiaries.
  2. I.R.C § 752(d) provides that the transfer of a partnership interest with debt in excess of basis will result in a gain to the extent of the negative capital account.
  3. However, as noted above, I.R.C. § 643(e) provides that a beneficiary will receive a carryover basis in property received in a distribution from a trust. Therefore, the question becomes whether I.R.C. § 643(e) overrides the principles of *Crane* and I.R.C. § 752(d). The answer to this is unclear.
  4. Gain will not be recognized if the decanting is between two grantor trusts because transactions between grantor trusts are disregarded for income tax purposes.

5. Gain will be recognized by the grantor if the decanting is between a grantor trust (the original trust) and a non-grantor trust (the second trust). I.R.C. § 643(e) does not control in this context because it does not apply to grantor trusts. *See* Treas. Reg. § 1.1001-2(c), Example 5.
  6. It can also be argued that even if negative basis assets are distributed in a decanting transaction, the fact that the second trust is seen as a continuation of the first trust should prevent the decanting from being a realization event.
- iv. While the same non-realization concept should apply for state income tax purposes, practitioners should also consider the effects of changing the situs of the trust through decanting.

b. Income to the Beneficiaries

- i. Distributing assets from one trust to another in a decanting transaction should not cause gain to the beneficiaries beyond what would otherwise be recognized by the beneficiaries.
- ii. In *Cottage Savings Ass'n v. United States* the Supreme Court held that gain is realized when a taxpayer exchanges properties that were materially different. The Service has expanded this to include when a beneficiary's interest in a trust is materially altered. *See* Treas. Reg. 1.643(b)-1.
- iii. In PLR 200743022, the Service clarified that decanting will not result in income to a trust's beneficiaries so long as the decanting is authorized by the trust instrument or state law.
- iv. The rationale being that the beneficiaries' interests were always subject to the Trustee's ability to decant so there has been no material change in the quality of the beneficiaries' interests. PLR 200810019.
- v. Beneficiaries would be required to recognize income only to the extent required by I.R.C. § 662(a). That is, the beneficiary would recognize income on the trust distribution to such beneficiary only to the extent of the trust's distributable net income ("DNI").
- vi. Because the transfer from the original trust to the second trust carried out the original trust's DNI to the second trust. The second trust would receive taxable income to the extent of the original trust's DNI, but the original trust would be entitled to a corresponding deduction under I.R.C. § 661(a) to the

extent of the original trust's DNI; therefore, there would be no income to the trusts in the aggregate (or double income to the beneficiary).

c. Gift Tax Consequences to the Beneficiaries or the Trustees

- i. Typically beneficiaries and Trustees should realize no gift tax consequences so long as the Delaware Tax Trap is avoided.
- ii. Gift tax consequences would result if the Trustee was also a beneficiary and the Trustee's discretion is not limited by ascertainable standard. I.R.C. § 25.2511-1(g)(2). However, this is not a problem in South Carolina because Trustee-beneficiaries are prohibited from exercising decanting authority. S.C. Code § 62-7-816A(e).
- iii. Gift tax consequences would result if the decanting required beneficiary consent. This is analogous to the release of a general power of appointment (the decanting would be considered a taxable gift by the beneficiary to the second trust). This is also not a problem in South Carolina because beneficiary consent is not required in order to decant. S.C. Code § 62-7-816A(a). It is only necessary that notice is given to the qualified beneficiaries.

iv. Delaware Tax Trap.

1. "If a power of appointment created after October 21, 1942, is exercised by creating another power of appointment which, under the applicable local law, can be validly exercised so as to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power, such exercise of the first power shall, to the extent of the property subject to the second power, be deemed a transfer of property by the individual possessing such power." I.R.C § 2514(d).
2. If the first power of appointment is exercised during life, gift tax consequences will result to the person who exercises that power. I.R.C. § 2514(d). If the first power is exercised at death, estate inclusion will occur under § 2041(a)(3).
3. South Carolina law which could trigger the Delaware Tax Trap:

- a. S.C. Code § 62-7-816A(d)(7) provides "The second trust may confer a power of appointment upon a beneficiary of the original trust to whom or for the benefit of whom the Trustee has the power to distribute principal or income of the original trust. The permissible appointees of the power of appointment conferred upon a beneficiary may include persons who are not beneficiaries of the original or second trust."
  - b. In South Carolina, a decanting is treated as the exercise of a special power of appointment by the Trustee. S.C. Code § 62-7-816A(f)(1).
4. The I.R.C. provisions addressing the Delaware tax trap appear broad enough to include a fiduciary power of appointment, but see below whether the transfer of property is treated as a "gift."
5. Therefore, the second trust may not include a power of appointment which is not subject to the same perpetuities period as the original trust, otherwise it will be considered a "transfer of property" and possibly a "gift" by the Trustee.
6. Other states (such as Virginia and Delaware) include a savings clause which prohibit the exercise of the second power of appointment in a way which would trigger this tax trap.
  - a. They do this by testing (for purposes of the rule against perpetuities) interests created under the power of appointment conferred in the second trust as if such interests had been established in the original trust.
  - b. "The power of appointment conferred upon a beneficiary shall be subject to the provision of §§ 55-12.1 through 55-13.3, covering the time at which the permissible period of the rule against perpetuities begins and the law that determines the permissible period of the rule against perpetuities of the original trust . . . ." Va. Code Ann. § 64.2-778.1(C)(8).
7. The easy solution is to include a limitation as to the exercise of the power of appointment conferred upon the beneficiary in the second trust.
8. A "transfer of property" is not necessarily a "gift."

- a. Some commentators have argued that while the law may be broad enough to classify a fiduciary power of appointment as a "transfer of property," it is not broad enough to classify it as a gift if the Trustee has no beneficial interest in the trust.
- b. While donative intent is not required in order for a transfer to be classified as a gift, Treas. Reg. § 25.2511-1(g)(1) provides that "[a] transfer by a Trustee of property in which he has no beneficial interest does not constitute a gift by the Trustee . . . ."

d. Estate Tax Consequences to the Beneficiary

- i. Generally estate tax consequences should not be triggered as a result of the decanting.
- ii. Estate tax inclusion will result for the beneficiaries of the second trust if the second trust gives such beneficiaries a general power of appointment. I.R.C. § 2041(a)(2).
- iii. Estate tax inclusion will result for the beneficiaries of the second trust if the decanting results in an incomplete gift that becomes complete on a beneficiaries death. Meaning the decanting had to, but for the inclusion of a testamentary limited power of appointment in the second trust, result in a completed gift, i.e. the Trustee-beneficiary situation described above.
- iv. Delaware Tax Trap. Estate inclusion is unlikely under the Delaware Tax Trap because the Trustee's exercise of his fiduciary power of appointment (in decanting the trust) cannot take place at the Trustee's death. Nevertheless, it is still advisable to include the savings clause discussed above.
- v. Sidenote: Estate inclusion may result for the original grantor if his (or a beneficiary's) involvement shows that the grantor had implied control over trust assets within the meaning of I.R.C. §§ 2036 or 2038.

e. GST Tax Consequences to the Beneficiary

- i. The regulations only address the decanting of grandfathered trusts; however, the Service has indicated they will apply the same rationale to trusts which are exempt from the GST tax because of the allocation of GST tax exemption. PLR 200743028.

- ii. A decanting will not cause a trust to lose exempt status if either the Discretionary Distribution Safeharbor or the Trust Modification Safeharbor is met.
- iii. Discretionary Distribution Safeharbor –Treas. Reg. § 26.2601-1(b)(4)(i)(A).
  - 1. When the original trust became irrevocable, either the terms of the original trust instrument or local law authorized the Trustee to make distributions to a new trust;
  - 2. Neither beneficiary consent nor court approval is required; and
  - 3. The second trust will not suspend or delay the vesting of an interest in trust beyond the federal perpetuities period, which is measured from the date the original trust became irrevocable to the later of:
    - a. A life in being plus twenty-one years; or
    - b. Ninety years.
- iv. Trust Modification Safeharbor – Treas. Reg. § 26.2601-1(b)(4)(i)(D).
  - 1. The decanting does not shift a beneficial interest to a beneficiary of a lower generation than the person holding the interest under the original trust; and
  - 2. The decanting does not extend the time for vesting of any beneficial interest beyond the period provided in the original trust.
- v. Consequences of losing the GST Exemption
  - 1. Service may argue that all future distributions are subject to GST tax;  
or
  - 2. The better argument is that GST tax should be imposed only when a distribution is made to a person who would have been unable to receive (without incurring GST tax) under the terms of the original trust.
  - 3. If a trust loses (or will lose) GST exemption, it may be possible to give a general power of appointment to a beneficiary in order to

trigger estate inclusion for that beneficiary, but avoid GST taxes upon the trust's termination.