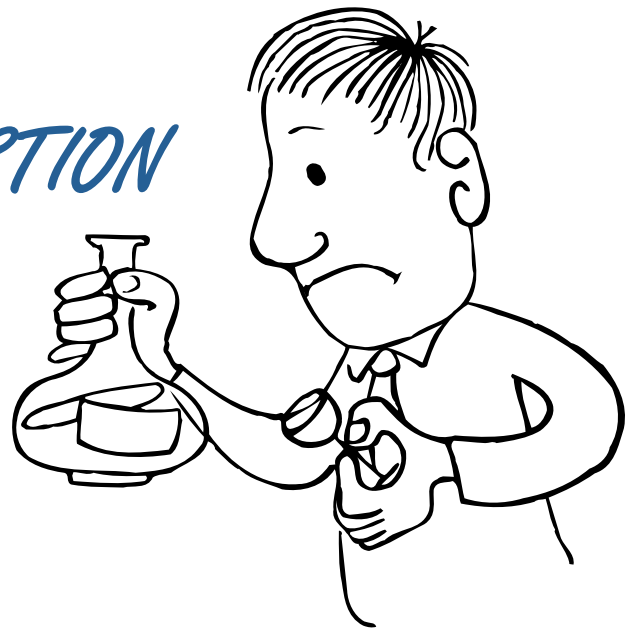


"DECANT OR NOT DECANT?"

THAT IS THE QUESTION

...with apologies to William Shakespeare

by T. James Lee | Fennemore Craig, P.C.



With its first anniversary of enactment upon us, Arizona Revised Statutes section 14-10819 remains a mysterious and somewhat controversial provision. Commonly referred to as decanting, section 14-10819 grants a trustee, under certain circumstances, the power to transfer assets from one trust to another.

The earliest decanting statute was enacted in 1992 by the State of New York. Nine additional states have since enacted statutes that can be characterized as granting a trustee power to decant (as of a recent survey): Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, North Carolina, South Dakota, and Tennessee. A decanting statute generally permits a trustee who has discretion to distribute trust principal to exercise statutory discretion to transfer such principal to a new trust. The new trust would have terms, conditions, and/or trustees that are different from the original trust. Most often the statutes will apply to trusts existing prior to the enactment date as well as trusts created since that time.

Arizona's decanting statute reads in its entirety as follows:

14-10819. Trustee's special power to appoint to other trust

- A. Unless the terms of the instrument expressly provide otherwise, a trustee who has the discretion under the terms of a testamentary instrument or irrevocable inter vivos agreement to make distributions, regardless of whether a standard is provided in the instrument or agreement, for the benefit of a beneficiary of the trust may exercise without prior court approval the trustee's discretion by appointing part or all of the estate trust in favor of a trustee of a trust under an instrument other than that under which the power to make distributions was created if the exercise of this discretion:
 - 1. Does not reduce any fixed nondiscretionary income payment to a beneficiary.**

2. *Does not alter any nondiscretionary annuity or unitrust payment to a beneficiary.*
 3. *Is in favor of the beneficiaries of the trust.*
 4. *Results in any ascertainable standard applicable for distributions from the trust being the same or more restrictive standard applicable for distributions from the recipient trust when the trustee exercising the power described in this subsection is a possible beneficiary under the standard.*
 5. *Does not adversely affect the tax treatment of the trust, the trustee, the settlor or the beneficiaries.*
 6. *Does not violate the limitations on validity under sections 14-2901 and 14-2905 [regarding non-vested interests and the rule against perpetuities].*
- B. This section applies to a trust governed by the laws of this state, including a trust whose governing jurisdiction is transferred to this state.*
- C. The exercise of the power to invade the principal of a trust under subsection A of this section is considered to be the exercise of a special power of appointment.*
- D. The trustee, in the trustee's sole discretion, prior to or after the exercise of the trustee's discretion under this section, may request the court to approve the exercise.*

There are a variety of reasons why the exercise of the Arizona decanting power might be desirable. Here are just a few examples:

- Correct a drafting error within an irrevocable trust.
- Alter the trusteeship.
- Modify beneficial interests or method of distribution.
- Change administrative provisions.
- Deal with unanticipated changes in tax law.
- Address changes in a settlor's tax objectives.
- Convert a trust to a special needs trust.

Some questions raised in connection with this relatively new statute include:

1. Can the decanting power be exercised in favor of a single beneficiary, to the exclusion of (or with diminution in benefits for) other named beneficiaries? (“for the benefit of a beneficiary of the trust” and “in favor of the beneficiaries of the trust”)
2. May decanting be accomplished on a non-pro rata basis? (“appointing part or all of the estate trust”) (Cf. A.R.S. § 14-10816(22).)
3. In the context of the requirement that the discretion exercised “not adversely affect the tax treatment of the trust, the trustee, the settlor or the beneficiaries”, how can this be clearly established? Take a situation in which a trustee decants from a non-grantor trust to a grantor trust. At first glance this would appear to create adverse tax treatment for the settlor. What if the settlor does not personally regard such tax treatment as being adverse to him or her, and instead considers it to be part of a more holistic and advantageous tax planning strategy?
4. What if the exercise of the decanting power would delay vesting beyond the rule against perpetuities period (as measured from the point in time that the original trust became irrevocable)—commonly referred to as the Delaware Tax Trap? A similar tax trap exists in connection with Arizona's perpetuity trust planning possibilities, or the ability of a powerholder or fiduciary to extend a perpetuities period via the exercise of a decanting power, merger power, or similar mechanism. (See IRC § 2041(a)(3).) Additionally, extending the term of an exempt (or partially exempt) post-1986 trust for generation-skipping transfer tax purposes is problematic.

Possible alternatives to decanting under A.R.S. § 14-10819 include, document-based decanting (where the decanting power is provided for in the governing instrument), trust modification (see A.R.S. § 14-10410 et seq.), trust merger (see A.R.S. § 14-10417), and document-based trustee powers to amend (where the trustee is independent of the settlor and beneficiaries).