

New Illinois Legislation: Trust Decanting

On August 10th, the Governor signed into law two bills (former HB 4662, now Public Act 97-0920, and former HB 4663, now Public Act 97-0921), making Illinois one of a growing number of states with statutes that address trust decanting and directed trusts. The new statutes will go into effect January 1, 2013. This client alert covers the trust decanting statute. Our prior client alert addressed the directed trust statute.

Section 16.4 is the new section added to the Illinois Trusts and Trustees Act (the “Act,” codified at 760 ILCS 5/1 *et seq.*) on trust decanting. Under the statute, a trustee with discretion to make distributions to a beneficiary of a trust (the “first trust”) may exercise that discretion by making the distribution to a separate trust (the “second trust”) instead of outright to the beneficiary. With the power to decant, a trustee may be able to address the needs of a disabled beneficiary; address out-of-date, incomplete, or inadequate administrative provisions; divide trusts; correct drafting mistakes; or address changed circumstances. Whether, and to what extent, the trustee may decant and what is permissible and impermissible for the terms of that second trust will depend on a number of factors, as described below.

Absolute Discretion vs. Non-Absolute Discretion

The scope of the trustee’s power to decant and the permissible terms of the second trust will largely depend on the type of discretion the trustee has under the first trust. The statute draws a distinction between a trustee who has absolute discretion and one who does not. Absolute discretion is defined as discretion “that is not limited or modified in any manner” and includes standards for distribution such as best interests, welfare, or happiness. 760 ILCS 5/16.4(a).

If the first trust grants the trustee absolute discretion to make distributions to more than one beneficiary, the second trust does not need to include all of the beneficiaries nor provide the same distributions as set forth in the first trust. The current beneficiaries of the second trust can be any one or more of the current beneficiaries of the first trust. The successor or remainder beneficiaries of the second trust can be any one or more of the remainder beneficiaries of the first trust. The distribution standard under the second trust may be the

same or different from the standard under the first trust.

The trustee may grant a power of appointment in the second trust to one or more of the current beneficiaries of the first trust. In addition, if a power of appointment is so granted, the class of permissible appointees may be broader than the class of current, successor, and presumptive remainder beneficiaries under the first trust. 760 ILCS 5/16.4(c).

Where a trustee does not have absolute discretion, the terms of the second trust must be substantially the same as those of the first trust. Under the statute, the second trust must have the same current, successor, and remainder beneficiaries as the first trust and must contain the same distribution standard(s). In addition, any power of appointment granted to a beneficiary in the first trust must be the same in the second trust. 760 ILCS 5/16.4(d).

The statute makes an exception to the foregoing rules if a beneficiary has a disability. For purposes of this exception, a disability is one “that substantially impairs the

beneficiary's ability to provide for his or her own care or custody and that constitutes a substantial handicap, whether or not the beneficiary has been adjudicated a disabled person." 760 ILCS 5/16.4(d)(4). If the trustee determines that it would be in the best interests of a disabled beneficiary, the trustee may distribute that beneficiary's interest into a second trust which is a supplemental needs trust. The distribution standard and provisions for the beneficiary in the supplemental needs second trust may be different from those of the first trust in order to qualify the beneficiary for governmental benefits.

Additional Terms/Prohibitions for Second Trust

In addition to the provisions regarding the permissible beneficiaries and their interest(s) for the second trust, the statute provides other rules for the second trust and the trustee's decision to decant. The statute expressly states that the trustee can decant from a first trust that is a grantor trust for income tax purposes to a second trust that is not. 760 ILCS 5/16.4(p)(1). The statute also provides that the second trust may have a longer term than the first trust, only limited to the same period under the rule against perpetuities applicable to the first trust, unless the first trust expressly permits the trustee to extend or lengthen the perpetuities period. 760 ILCS 5/16.4(g) and (n)(4). Except for a second trust that is a supplemental needs trust, the terms of the second trust cannot eliminate a beneficiary's current right to mandatory distributions, whether of income or an annuity or unitrust amount, or eliminate a beneficiary's right of withdrawal that has come into effect. 760 ILCS 5/16.4(n)(1), (o).

The statute prohibits a trustee from decanting to a second trust that has certain provisions that may present a conflict of interest for the trustee. First, the second trust cannot decrease, eliminate, or indemnify against a trustee's liability or exonerate a trustee from liability in a manner not provided by the first trust. The *reallocation* of trustee responsibility and liability is, however, permitted. The second trust may "unbundle the governance structure of a trust" and divide and separate responsibilities among several parties, such as between one or more trustees, or to a distribution advisor, investment advisor, or trust protector. 760 ILCS 5/16.4(n)(2). So long as the fiduciary responsibility is not reduced, this type of reallocation under a second trust is permitted. For example, if the first trust

has co-trustees who must act jointly, but the second trust vests one trustee with sole responsibility and liability to make distribution decisions and the other trustee with sole responsibility and liability to make investment decisions, this allocation of fiduciary responsibility would be permissible. However, if the terms of the second trust also exonerate the trustee with investment responsibility from his or her own negligent actions or inactions, and the first trust contains no such exoneration, decanting to the second trust would not be permissible.

The statute prohibits a trustee from decanting to a second trust that eliminates another person's right to remove and replace the trustee. However, the second trust may give this power to an "independent, non-subservient individual or entity, such as a trust protector, acting in a nonfiduciary capacity." 760 ILCS 5/16.4(n)(3).

Finally, the statute prohibits a trustee from decanting to a second trust solely to change the trustee's compensation unless authorized by court or unless the second trust is created for other valid and reasonable purposes and the change to the trustee's compensation brings it [sic] with reasonable limits under Illinois law. 760 ILCS 5/16.4(q).

The statute contains certain tax-savings provisions for decanting a trust. The trustee cannot exercise the power to decant in a manner that would cause the trust to lose certain tax benefits, such as qualification for the annual exclusion under Code Section 2503(b), qualification for the marital deduction or charitable deduction, qualification for certain treatment as a direct skip under Code Section 2642(c), or, for a trust that holds S corporation stock, qualification as an S corporation shareholder. In addition, if the first trust holds an interest in an IRA or other qualified plan, the trustee may not distribute to a second trust that would shorten the minimum distribution period for that qualified plan. 760 ILCS 5/16.4(p).

Notice/Consent

The statute requires the trustee to provide notice of a decision to decant but does not otherwise require the consent of another party, including the settlor of the trust, a beneficiary, or the court, if there is at least one competent current and one competent remainder beneficiary. The trustee must send 60-days' prior written notice of the trustee's decision to decant to all legally

competent current beneficiaries and presumptive remainder beneficiaries. If a charity is a current beneficiary or presumptive remainder beneficiary of the trust, the notice must also be sent to the Attorney General's Charitable Trust Bureau. 760 ILCS 5/16.4(e). If a beneficiary does object, then the trustee (or other interested beneficiary) can petition a court regarding the decision to decant. 760 ILCS 5/16.4(f). In a situation where there are no competent current beneficiaries or no competent presumptive remainder beneficiaries, the trustee should consider seeking court approval of a decision to decant.

Trustee Duty and Liability for Decision to Decant

The statute provides that an independent trustee who decides to decant must exercise his or her discretion in a fiduciary capacity and in furtherance of the purposes of the trust. 760 ILCS 5/16.4(b). However, the statute expressly states that it does not create or imply a duty on a trustee to decant, to notify the beneficiary of the power to decant, and to review the trust to determine whether it would be appropriate to decant. 760 ILCS 5/16.4(l).

If the trustee decides to decant, the trustee may for any reason elect to petition the court to order the distribution. In a judicial proceeding, the trustee may, but is not required to, provide the trustee's support of or opposition to a proposed distribution. The trustee's actions are not considered a breach of the duty of impartiality unless, from all evidence, it appears the trustee acted in bad faith. 760 ILCS 5/16.4(f).

The statute states that any act or omission by a trustee with respect to decanting is presumed taken or omitted reasonably and in good faith unless it is determined by the court to have been an abuse of discretion. Any claims by any interested person against a trustee for any act or omission by the trustee with respect to decanting are barred unless begun within two (2) years after receiving notice. 760 ILCS 5/16.4(u).

Applicability and Opt-Out

The decanting statute is identified as relating to the administration of a trust and is available to any trust

(including any trust created prior to the effective date of the statute) that is administered in Illinois under Illinois law or that is governed by Illinois law with respect to the meaning and effect of its terms, including a trust whose governing law has been validly changed to Illinois. However, a settlor or testator, under a governing instrument, may expressly prohibit decanting by specific reference to the statute. 760 ILCS 5/16.4(v).

Tax Implications

Although the power to decant may be viewed as a possible way to resolve certain problems or issues in the administration of the trust, the tax implications for decanting should be carefully considered. In 2011, the IRS stated that it was studying the tax implications for decanting from one irrevocable trust to another irrevocable trust and, in the meantime, would no longer issue private letter rulings in this area. Notice 2011-101.

A number of tax questions may be raised in decanting a trust. Among the questions raised on the income tax side are: (1) does the distribution carry out distributable net income (DNI), (2) is the distribution of appreciated property a realization event, (3) does the grantor of the first trust remain grantor of the second trust, and (4) if all assets are distributed, do carryover items for the first trust, such as carryover losses, net operating losses or deductions in excess of income, carry over to the second trust? On the gift and estate tax side, if the beneficiaries and their interests under the second trust are not identical to the first trust, did the beneficiary whose interest is "diminished" make a taxable gift or make a transfer that would trigger estate tax inclusion under Code Section 2036 or 2038? Finally, on the generation-skipping transfer (GST) tax side, does the second trust have the same GST tax status (as an exempt trust, taxable trust, or grandfathered trust) and the same GST inclusion ratio, and is the transferor of the first trust still considered the transferor of the second trust?

Some of these tax issues are answered (or at least a good property law basis for argument is provided) by the terms of the decanting statute. The statute provides that the settlor of the first trust is considered for all purposes to be the settlor of any second trust established in accordance with the statute, or at least with respect to the portion of the second trust distributed from the first trust. Although

this statement within the statute only defines the settlor of the second trust as a matter of Illinois trust or property law, it provides the basis for arguing this same treatment for income, gift, estate and GST tax purposes as well. This statement in the statute would also imply that, for Illinois income tax purposes, the tax residency of the second trust (or that portion of the second trust which was a distribution from the first trust) would be the same as the tax residency of the first trust since Illinois determines the residency of a trust based on the domicile of the grantor of the trust at the time it became irrevocable.

In addition to the foregoing, the decanting statute has a number of specific tax savings provisions and a general tax savings statement that prohibits decanting from eliminating tax exclusions or triggering certain tax results. These savings provisions may protect against a negative tax result by allowing the trustee and/or beneficiaries to “unwind” an impermissible decanting.

If you would like to discuss any of the issues addressed in this Client Alert or would simply like to find out more about Chapman, please contact any attorney in Chapman’s Trusts and Estates Department or visit us online at chapman.com.

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