

# Decanting & Fiduciary Risk: Just Because You Can, Does Not Mean You Should

## 15 Tips to Minimize Fiduciary Risk for A Successful Trust Decanting

BY MICHAELLE D. RAFFERTY, ESQ.

**Decanting a bottle of wine is designed to make a good bottle better. The same is true when decanting a trust. Nevada is a leading jurisdiction for decanting trusts to produce a more effective trust with its broad and powerful decanting statute.<sup>1</sup> But despite the broad authority and benefits, there are risks to the fiduciaries who decant. The concerns are often directed at tax issues, but with fiduciary litigation on the rise, trustees around the country are facing increased challenge at the state level from beneficiaries, grantors, creditors, and other fiduciaries.**

Accordingly, the following tools seek to mitigate fiduciary risk when contemplating a trust decanting.

### 1. Identify Decanting Objectives:

Decanting is one, but not the only, tool to update or modify terms of a trust. Before decanting, identify the problem to be solved, and consider the decanting option as well as other options such as reformation, modification, revocation, merger,

and use of available powers of appointment. Decanting is undertaken by a trustee subject to fiduciary risks while other techniques may be available to accomplish the objective without the same level of fiduciary risk. For example, there may be a non-fiduciary trust protector who can act to accomplish the end goal without the same fiduciary obligations.

### 2. Review the Trust Instrument:

Start with a thorough review of the trust instrument for authority and limits. Trust instruments may specifically authorize, restrict, or prohibit decanting, and may contain statements of the grantor's intent that limit the scope of what can be accomplished through decanting. Restrictions and grantor intent can be buried in a variety of places within the trust instrument and, accordingly, the instrument should be reviewed in its entirety.



**3. Trust Validity:** In order to be decanted, the trust must be a valid irrevocable trust. Trustees must identify the governing law determining issues of validity and construction. While Nevada counsel may be able to assist, if validity will be determined by the law of another jurisdiction, the trustee may need to seek the opinion of counsel in the applicable jurisdiction to confirm validity.

**4. Confirm Distribution Authority:** Decanting is premised on the trustee having broad discretion to distribute principal and/or income to a beneficiary. Accordingly, if the trustee lacks discretion, decanting may not work (i.e., consider a Qualified Terminal Interest Property [QTIP] Trust as to mandatory income). Where a trustee's discretion will arise in the future (i.e., upon occurrence of an event), the trustee should be cautious. Anticipatorily decanting is not prohibited under Nevada law but may not be effective until the discretionary power vests.

**5. Importance of Form and Substance:** Decanting is one technique where the "form" of the decanting is just as important as the "substance" of the action. Form and timing are not irrelevant.<sup>2</sup> For example, it may be necessary to relocate the trust situs to Nevada before utilizing Nevada's decanting statute. Merely appointing a Nevada trustee may be insufficient where the trust instrument is inflexible and contains notice requirements before a change in trustee, situs, and place of administration is effective. Sufficient time should be provided to avoid inadvertent mistakes in the process.

**6. Acting on the Advice of Counsel:** Decanting can be a collaborative process. It is not uncommon for counsel for one or more of the grantors, beneficiaries, resigning trustee, or trust protector to prepare draft instruments necessary for

the decanting. Regardless of the drafter, the trustee should consider obtaining advice of counsel for its own compliance. Relying on the good advice of others may be sufficient to confirm legalities of the process, but the trustee will not have the ability to claim reliance on such counsel due to lack of privity. Where one lawyer is representing various parties including the trustee, evaluation of engagement terms, conflicts of interest, and obtaining waivers may be appropriate to confirm representation.

**7. Tax Implications:** Decanting a trust may trigger income, estate, and gift tax implications. For example, the original trust may be exempt from generation-skipping taxes, may be a non-grantor trust for income tax purposes, and may involve gift tax implications due to negotiated modifications and consents. Accordingly, trustees should consult with qualified tax advisors before decanting. In some circumstances, it may be appropriate to seek (or offer to seek) an advance ruling from the Internal Revenue Service<sup>3</sup> prior to decanting. Although this request can delay the decanting process and increase costs, it can also provide a shield for the trustee and beneficiaries to avoid unintended consequences. Even where a tax ruling is not sought, documenting the evaluation of tax issues can be important should a challenge later arise.

**8. Notice of Proposed Action:** Nevada does not require a trustee to issue a Notice of Proposed Action (NPA) to decant. Issuing an NPA may not be appropriate in all cases, and the decision rests with the trustee. For example, a silent trust that mandates confidentiality may indicate the grantor's intent was to forego such notices. But a NPA can be a trustee's best friend due to the release from personal liability it provides.<sup>4</sup> When notice is coupled with disclosure of the new trust terms, identification of risks and rewards, and tax implications, the

NPA can significantly eliminate or minimize fiduciary risk. NPAs can also facilitate discussions between the trustee and beneficiaries.

**9. Grantor Participation:** Involving a living grantor can be helpful. Grantors add insight through extrinsic evidence and can coordinate communications with beneficiaries. But use caution. A grantor may have a self-serving memory. Further, taxing authorities may view the grantor's involvement as an act of control in violation of Section 2036 of the Internal Revenue Code of 1986, as amended.

**10. Identifying Interested Persons:** The Doctrine of Virtual Representation is codified under Section 164.038 of the Nevada Revised Statutes and allows a beneficiary to represent those who would subsequently take after the beneficiary. This provision can eliminate the need for guardian ad litem for minors or unborn and can significantly reduce the time and cost. Nevertheless, if a decanting provides a benefit that places the beneficiary in a conflict with subsequent beneficiaries, then virtual representation will not work. Trustees should evaluate whether all beneficiaries and beneficial classes are represented for NPA and Non-Judicial Settlement Agreement (NJSAs) purposes.

**11. Non-Judicial Settlement Agreements:** Nevada recognizes the ability of indispensable parties to enter a NJSAs as part of the decanting process.<sup>5</sup> A NJSAs can be used to modify a trust so long as it does not violate the grantor's intent, and so long as the court could take that same action. Coupling a decanting with an NPA and NJSAs can document the trustee's due diligence through recitals and confirm beneficiary consent. However, while NJSAs solve state law issues, NJSAs do not eliminate tax concerns. Taxing

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authorities may view the NJSA as a waiver of rights and therefore a gift between parties. For example, termination of a QTIP trust by NJSA may trigger gift tax complications.<sup>6</sup> While state law provisions may permit a trust termination by agreement, trustee must monitor the impact of a such an agreement in relation to the tax implications.

**12. Court Approval:** NRS 164.010 provides an efficient means of admitting a trust to the jurisdiction of a Nevada court, and NRS 164.035 permits the court to instruct the trustee. Court proceedings in Nevada are relatively efficient compared to most other states and Nevada's judiciary has been supportive to the petition process in trust matters. Court review provides a forum for disputes, disclosure, and notice to all interested persons. The court can confirm that the NPA and NJSA are valid. The benefits should be weighed against lack of privacy, cost and whether it will be binding on taxing authorities.<sup>7</sup> It may be necessary where virtual representation is not available.

**13. E&O Coverage and Limitations of Self-Serving Releases:** Fiduciaries should review fiduciary coverage and understand its limits. Lack of coverage may be a reason to use an NPA/NJSA, and/or court review, even if not required under Nevada law. Trustees should also be cautious when a decanting will alter the fiduciary's liability standard, or release and indemnify the trustee moving forward. Absent disclosure, a court may later strike the release and indemnity provisions where undisclosed self-dealing is found to have occurred.

**14. Provisions Warranting Further Consideration:** Decanting that attempts to (1) extend the perpetuities vesting period of the original trust; (2) alters the dispositive provisions in a manner that eliminates distribution standards (i.e., removing a Health, Education, Maintenance, and Support (HEMS) standard); (3) alters governing law; (4) alters the prudent investor standards; (5) eliminates a beneficiary; and (6) grants powers to persons other than the trustee (i.e., trust protectors) may be permissible but can create conflicts. A detailed review of these items is beyond

the scope of this article. But these areas tend to be the focus of reported litigation surrounding decanting.

**15. Combining Techniques & Multiple Decantings:** When one technique or decanting will not solve all desired issues, consider combining risk management techniques and addressing issues through multiple decantings.

Decanting is a powerful tool, and its benefits continue to make it the tool of choice for trust and estate advisors. But even if permitted, trustees should conduct due diligence for tax implications, grantor intent, and fiduciary standards, and they should document such efforts in order to minimize risk of challenge and further to increase probability of a successful decanting.

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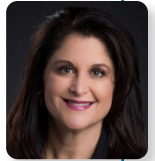
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## ENDNOTES:

1. Section 163.556 of the Nevada Revised Statutes authorizes a trustee to decant a trust that has a Nevada situs, is governed by Nevada law, or that is administered under Nevada law.
2. *Smaldino v. Commissioner*, No. 5437-18 (USTC Nov. 10, 2021)
3. The IRS has continued to take no position on the tax consequences of decanting. See PLR 108363-19 for an example of such declination. However, the IRS has issued numerous PLRs on trust modifications and exercises of powers of appointment.
4. NRS 163.556(7); NRS 164.725
5. NRS 164.940 et. seq.
6. See *Kite v. Commissioner*, Rule 155 Order and Decisions (Cause No. 672-08) unpublished opinion October 25, 2013); and Letter Rulings 201932001-201932010 for examples of negative tax implications of early termination of trusts through settlement.
7. *Commissioner v. Bosch*, 387 US 456 (1967)

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