

Trust Decanting: Income, Gift, Estate, & GST Tax Consequences

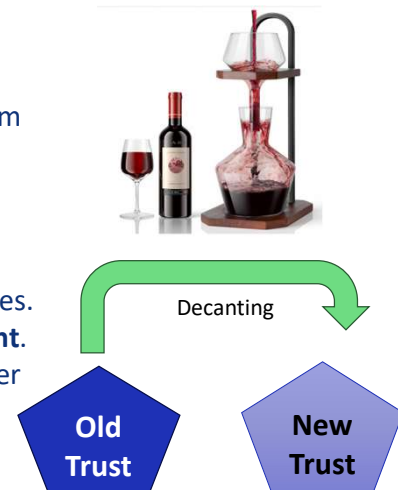
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What is Trust Decanting?

- **Decant:** to pour out, transfer, or unload as if by pouring.
 - Analogy of pouring of a liquid.
- **Decanting** is the process by which a trustee distributes assets from one irrevocable trust (the “Distributing Trust”) to another (the “Receiving Trust”), often to modify terms or adapt to changed circumstances.
- Trustee exercises fiduciary power to invade principal (or income).
- Assets are distributed **in further trusts** for beneficiary/beneficiaries.
- Analogous to exercise of a **limited (special) power of appointment**.
- Generally, no beneficiary consent or court approval required under most statutes.



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Why Decanting is Used?

- **Purpose:** Update trust provisions, address beneficiary needs, or respond to changes in law.
- Could be to fix outdated tax planning (grantor status, GST leverage, unforeseen tax changes, and state laws).
- Modify administrative provisions without judicial action/court approval.
- Can be used to address changed family circumstances, inefficiencies, correct drafting errors, help with creditor concerns, protecting tax treatment, and other issues.
- Sever trusts or align trust terms with modern trust law/tax laws.



Decanting Compared to Trust Modification

- Decanting = discretionary distribution (not generally consider a beneficiary transfer).
- Non-judicial Settlement Agreement / modification may require consent → could increase gift tax risk.
- IRS distinguishes fiduciary action from beneficiary acquiescence.



Income, Gift, Estate, and GST Tax Consequences with Decanting

- There is relatively little developed tax law on the federal tax consequences of trust decanting, especially when beneficial interests are changed.
 - Analogies to other transfers is often used as a substitute.
- IRS Notice 2011-101 acknowledges this lack of guidance and requests public comments on the income, gift, estate, and GST tax implications of decanting.
 - Notice 2011-101 identifies various factors affecting tax consequences, such as changes in beneficiaries, trust situs, and whether the trust is grantor or non-grantor.
- The IRS will not issue private letter rulings (PLRs) for decantings that change beneficial interests, highlighting the uncertainty in this area.
- Taxpayers/tax practitioners should proceed with caution and monitor ongoing IRS guidance and case law with considering trust decantings.

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Income Tax Framework

- Decanting treated as discretionary trust distribution.
- Generally not a sale or exchange under IRC § 1001.
- Analogy: trustee distribution, not exercise of pecuniary “power of appointment”.
- Grantor trust vs. non-grantor trust status may change after decanting.
 - Grantor Trust: The grantor (creator) is treated as the owner of trust assets for income tax purposes.
 - All income, deductions, and credits attributable to the trust are reported directly on the grantor’s personal tax return (IRS Form 1040).
 - Non-grantor Trust: The trust is recognized as a separate taxpayer
 - Trust income is taxed at the trust level unless distributed to beneficiaries, in which case beneficiaries report the income on their own returns. The trust files its own tax return (IRS Form 1041) and pays tax on undistributed income.
- If trust remains a grantor trust, income tax consequences are generally unchanged.
- If decanting results in a new grantor trust or changes grantor status, income tax reporting may be affected.



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DNI and Trust Continuity

- Distributable Net Income (DNI) is a tax concept defined in IRC § 643(a) as the taxable income of the trust, with specific modifications.
 - DNI limits the deduction a trust can take for distributions to beneficiaries and determines the amount and character of income that beneficiaries must include in their gross income.
- DNI follows the property.
 - If assets are distributed from the original trust to a new trust, DNI is allocated between the trusts based on the portion of income and deductions attributable to each, using a reasonable and equitable method.
- Complete decanting often treated as same trust for income tax.
- Several Private Letter Rulings (PLRs) suggest carryover of tax attributes and possible reuse of EIN.
- However, when a trust is decanted, the DNI calculation *may be* affected if the decanting results in distributions to beneficiaries or changes in the allocation of income and principal.

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Non-Recognition of Gain

- Decanting generally does not trigger gain or loss if assets are transferred in kind and beneficial interests are unchanged.
 - Non-recognition event (i.e., not a sale or exchange)
- Basis of assets typically carries over to the new trust.
- No gain under IRC §643(e) unless trustee elects recognition.
- Decanting generally avoids IRC §1001 realization.
- Beneficiaries taxed only to extent of DNI.

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Negative Basis Assets

- Possible gain if liabilities exceed basis.
 - Negative basis assets: liabilities/liability exceed the property's income tax basis.
 - Review for potential of "negative basis" assets prior to decanting.
- Risk heightened:
 - Grantor → non-grantor trust conversion.
 - Different deemed owner post-decanting.
- Often reason to exclude asset from decanting.



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Gift Tax: Beneficiaries

- **Section 2501** imposes gift tax on transfers by gift
- Gift tax generally requires voluntary transfer.
- No gift by the beneficiary if beneficiary lacks legal right to prevent decanting.
- Mere acquiescence ≠ taxable gift.
- If decanting does not change beneficial interests, no gift occurs.
- If a beneficiary's interest is reduced or a new beneficiary is added, a taxable gift may result by the beneficiary whose interest is diminished.
- Examples
 - Decanting to a new trust with identical beneficiaries and interests (No gift).
 - Decanting to add a new beneficiary or alter distribution rights (Potential gift).



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Gift Tax: Consent Trap?

- Beneficiary consent or failure to object may be treated as gift
- IRS position highlighted in CCA 202352018 (IRS's litigation position)
- Facts:
 - Grantor establishes irrevocable grantor trust.
 - Neither state law or trust instrument allowed Trustee to make distributions to A to satisfy A's income tax liability (grantor trust).
 - Beneficiaries consented to the trust modification.
 - **Result:** Beneficiaries deemed to have made a taxable gift.
- Higher risk when beneficial interest(s) is reduced or shifted + beneficiary "consent"

Office of Chief Counsel
Internal Revenue Service
memorandum

Number: 202352018
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UILC: 2511.04-00

date: November 28, 2023

to: Janice B. Gailer
Associate Area Counsel, Portland
(Small Business/Self-Employed))

Sheila R. Pattison
Associate Area Counsel, Austin
(Small Business/Self-Employed)

from: Holly Porter
Associate Chief Counsel
(Passthroughs & Special Industries)

subject: Gift tax consequences of modifying a grantor trust to add a tax reimbursement clause

Issue

What are the gift tax consequences to the beneficiaries when the trustee of an irrevocable trust, with respect to which the grantor is treated as the owner under subpart E, part 1, subchapter J, chapter 1 (subpart E) of the Internal Revenue Code (Code), modifies the trust, with the beneficiaries' consent, to add a tax reimbursement clause that provides the trustee the discretionary power to make distributions of income or principal from the trust in an amount sufficient to reimburse the grantor for the income tax attributable to the inclusion of the trust's income in the grantor's taxable income?

Conclusion

The modification to add the tax reimbursement clause will constitute a taxable gift by the trust beneficiaries because the addition of a discretionary power to distribute income and principal to the grantor is a relinquishment of a portion of the beneficiaries' interest in the trust.



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Trustee-Beneficiary Issues

- Question: Does the power of a beneficiary-trustee to decant have gift tax consequences?
- Beneficiary-trustee participation could raise IRC §§2514 / 2041 concerns.
- Safe harbor: distributions limited to health, education, maintenance and support (HEMS).
- Most statutes prohibit beneficiary-trustee decanting beyond this standard.



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Estate Tax Considerations

- **Section 2033:** Estate includes all property in which decedent had an interest at death.
- Decanting itself generally estate tax-neutral.
- If decanting does not alter the decedent's retained interests or powers, estate inclusion is generally unaffected.
- Estate inclusion arises if (sections 2036-2038):
 - General power of appointment is granted.
 - Beneficiary participates beyond ascertainable standard.
 - Decanting changes/creates retained interests.
- Removal & replacement power analysis still relevant.

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What is GST Tax?/Grandfathered Trusts

- The GST tax is a federal tax imposed on transfers of property (by gift or at death) to individuals who are two or more generations below the transferor (e.g., grandchildren), or to certain trusts for their benefit.
 - Designed to prevent families from avoiding estate and gift taxes by transferring wealth directly to grandchildren or more remote descendants, thereby "skipping" a generation of transfer taxes.
 - Ensures that transfer taxes are paid at each generation, maintaining the integrity of the estate and gift tax system.
- **Grandfathered Trusts:** irrevocable trust (and distributions from it) created before September 26, 1985, is generally exempt from GST Tax (unless additions made after that date).
- Protected if:
 - Authority existed at trust creation (instrument or common law)
 - No beneficiary consent or court approval required
 - Vesting not extended beyond federal perpetuities period

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Decanting of GST-Exempt (Allocated) Trusts

- Allocation generally preserved if no new transferor is created
- IRS applies grandfathering concepts by analogy.
 - If a trust is exempt by GST allocation, the trust can remain GST exempt after the decanting.
 - If a GST-exempt (allocated) trust is decanted, the GST exemption generally carries over to the new trust if the decanting does not shift beneficial interests to lower generations or extend the trust's duration.
 - If decanting changes beneficial interests (e.g., adds new skip persons or delays vesting), the trust may lose its GST-exempt status, and the new trust (or a portion) could become subject to GST tax.
- Decanting is sometimes used for GST severances & inclusion-ratio planning.
- The IRS has not issued comprehensive guidance on the GST consequences of decanting; each situation must be analyzed based on the specific facts, trust terms, and applicable state law.

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Decanting Tax Considerations & Takeaways

- Decanting is powerful tool but tax-sensitive.
- Document the decanting process and rationale to support the intended tax treatment in the event of IRS scrutiny.
- Avoid beneficiary consent where possible.
- Lack of IRS Authority and Treasury Guidance
 - IRS Notice 2011-101: IRS is studying tax consequences of decanting, especially when beneficial interests change.
 - No private letter rulings (PLRs) issued if decanting changes beneficial interests; PLRs may be issued if no change in beneficial interests.
- Scrutinize negative basis assets and power of appointment (POA) creation
- GST Considerations/drafting around perpetuities is critical
- Coordinate tax, fiduciary, and state-law analysis
 - Carefully review the "Distributing Trust"/ "Old Trust" and "Receiving Trust(s)" / "New Trust(s)"

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