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It Seemed Like a Good Idea at the Time: Making Changes to an Irrevocable Trust

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Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

Mr. Redd is a member of the State Bar of Wisconsin, The Missouri Bar, the Illinois State Bar Association, The Bar Association of Metropolitan St. Louis and the Estate Planning Council of St. Louis.

Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award. Mr. Redd was the principal draftsman of the Missouri Family Trust Company Act.

Mr. Redd is an elected member of The American Law Institute and a Fellow of The American College of Trust and Estate Counsel (Past Missouri State Chair; Past Regent; Past Chair of Communications Committee; Estate and Gift Tax Committee; and Fiduciary Litigation Committee). He was an adjunct professor of law (Estate Planning) at Northwestern University School of Law for fifteen years. He serves as Co-Chair of the Editorial Advisory Board of, and writes a regular column in, Trusts & Estates magazine. In 2018, he was inducted into the Estate Planning Hall of Fame® by the National Association of Estate Planners and Councils. Mr. Redd is listed in The Best Lawyers in America and is "Band 1" ranked by Chambers and Partners in their High Net Worth guide. He frequently writes and lectures nationally on topics in the trusts and estates field.

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I. INTRODUCTION

The commonly understood definition of "irrevocable" is: unchangeable, unalterable, immutable, cast in stone, not able to be revoked.[1] During the past couple of decades, however, the term "irrevocable," as used in estate planning, has taken on a new, counter-intuitive meaning. In the 21st century, a trust that is said to be irrevocable[2] is, in truth, often nothing of the sort. Indeed, a provision in a trust instrument saying the trust is irrevocable, or the irrevocable nature of a trust because of the death of the settlor, may, in 2022, be a mere minor impediment to making changes to the trust.

II. THE PURSUIT OF FLEXIBILITY

Flexibility in estate planning is almost universally touted as the greatest thing since sliced bread. Contemporary estate planning professionals seem consistently to accept and promote the use of techniques and strategies, enabled or enhanced by the developments described below, that can be and sometimes are used to eviscerate a trust. Of course, changes to irrevocable trust instruments are often objectively desirable or necessary. Errors need to be corrected. Antiquated, obsolete provisions need to be updated. Unanticipated changes in applicable law and beneficiaries' circumstances need to be addressed. Sometimes, though, the motivation to make changes, and the changes themselves, may transcend that which is desirable or necessary. Beneficiaries may simply decide they don't care for the terms of a trust established by an ancestor and want to relax the rules or eliminate restrictions altogether. Indeed, a determined coalition of beneficiaries who are willing to expend sufficient time, effort, patience and money may well be able to effectuate virtually any change in trust provisions they desire.

III. METHODS OF CHANGING OR TERMINATING AN IRREVOCABLE TRUST

Numerous legal mechanisms have evolved to facilitate reformation, modification, rescission, termination and decanting of irrevocable trusts. Of particular note are the following:

[1] *See* Merriam Webster's Collegiate Dictionary, Eleventh Edition (2020).
[2] A trust may be irrevocable because it was designed and established as such from the outset or because the testator under whose Will it was created, or the settlor, in the case of a revocable trust, has died.

A. Uniform Trust Code

The Uniform Trust Code ("UTC") -- enacted in thirty-five states[3] and the District of Columbia, and introduced in New York State during the 2021 legislative session -- provides several avenues through which the terms of a trust can be changed.

- UTC § 111 allows interested persons to enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust so long as a material purpose of the trust is not thereby violated.[4] Presumably, to invoke UTC § 111, there must be a matter that requires resolution, but that would appear to be an easily surmountable challenge.

- UTC § 411(a) authorizes the settlor and all beneficiaries to modify or terminate a noncharitable irrevocable trust, even if the modification or termination is inconsistent with a material purpose of the trust.[5] An alternative version of UTC § 411(a) requires the court to approve such a modification or termination where the court finds that the settlor and all beneficiaries have consented to it.

- UTC § 411(b) provides that the court may order a modification or termination of a noncharitable irrevocable trust if all beneficiaries consent to the modification or termination and the court concludes that, in the case of modification, such action is not inconsistent with a material purpose of the trust or, in the case of termination, continuance of the trust is not necessary to achieve any material purpose of the trust.[6] Material purposes are not readily to be inferred.[7]

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[3] Ala. Code §§ 19-3B-101 to 19-3B-1305, Ariz. Rev. Stat. §§ 14-10101 to 14-11102, Ark. Code §§ 28-73-101 to 28-73-1105, Colo. Rev. Stat. §§ 15-5-101 to 15-5-1404, Conn. Gen. Stat. §§ 45a-499a to 45a-500s, D.C. Official Code §§ 19-1301.01 to 19-1311.03, Fla. Stat. §§ 736.0101 to 736.1303, 760 ILCS 3/101 to 760 ILCS 3/9999, Kan. Stat. §§ 58a-101 to 58a-1107, Ky. Rev. Stat. §§ 386B.1-010 to 386B.11-050, 18-B Maine Rev. Stat. §§ 101 to 1104, Md. Code, Estates and Trusts §§ 14.5-101 to 14.5-1006, Mass. Gen. Laws §§ 203E, §§ 101 to 1013, Mich. Comp. Laws §§ 700.7101 to 700.8206, Minn. Stat. §§ 501C.0101 to 501C.1304, Miss. Code §§ 91-8-101 to 91-8-1206, §§ 456.1-101 to 456.11-1106, RSMo., Mont. Code §§ 72-38-101 to 72-38-1102, Neb. Rev. Stat. §§ 30-3801 to 30-38,110, N.H. Rev. Stat. 564-B:1-101 to 564-B:12-1206, N.J. Stat. 3B:31-1 to 3B:31-84, N.M. Stat., §§ 46A-1-101 to 46A-11-1105, N.C. Gen .Stat. §§ 36C-1-101 to 36C-11-1104, N.D. Cent. Code §§ 59-09-01 to 59-19-02, Ohio Rev. Code §§ 5801.01 to 5811.03, Ore. Rev. Stat. §§ 130.001 to 130.910, 20 Pa. Cons. Stat. §§ 7701 to 7799.3, S.C. Code §§ 62-7-101 to 62-7-1106, Tenn. Code §§ 35-15-101 to 35-15-1103, Utah Code §§ 75-7-101 to 75-7-1201, 14A Vt. Stat. §§ 101 to 1204, Va. Code §§ 64.2-700 to 64.2-808, W. Va. Code §§ 44D-1-101 to 44D-11-1105, Wis. Stat. §§ 701.0101 to 701.1013, Wyo. Stat. §§ 4-10-101 to 4-10-1103.

[4] *But see* Section 456.1-111.6, RSMo., which states "A nonjudicial settlement agreement may not be used to terminate or modify a trust [to reduce or eliminate the interests of some beneficiaries and increase those of others, change the times or amounts of payments and distributions to beneficiaries or provide for termination of the trust at a time earlier or later than that specified by its terms].

[5] Not at all a revolutionary concept. *See* RESTATEMENT (THIRD) OF TRUSTS (2003) § 65; RESTATEMENT (SECOND) OF TRUSTS (1959) § 337.

[6] Like Uniform Trust Code ("UTC") § 411(a), UTC § 411(b) did not represent a departure from the common law. It merely put into statutory language the Claflin doctrine (*see Claflin v. Claflin*, 149 Mass. 19, 20 N.E. 454 (1889)), which had been followed by a large majority of states.

[7] RESTATEMENT (THIRD) OF TRUSTS (2003) § 65 cmt. d. This principle is referenced favorably in the Comment on UTC § 411 provided by The National Conference of Commissioners on Uniform State Laws.

- Under UTC § 412(a), the court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust.[8]

- UTC § 415 allows the court to reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence what the settlor's intention was and that the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement.

- UTC § 416 states that, to achieve the settlor's tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention.

- UTC § 108 provides, among other things, that the trustee, after having given proper notice to "qualified beneficiaries," may transfer the trust's principal place of administration to another state. Transferring the principal place of administration will normally change the governing law to that of the transferee state with respect to administrative matters.[9] In some instances, selected statutes of the state to which a trust's principal place of administration has been transferred are explicitly made available to be used by such trust.[10]

B. Trust and Estate Dispute Resolution Act

Lawmakers in two states[11] have enacted the Trust and Estate Dispute Resolution Act ("TEDRA"). Under TEDRA, all interested parties can enter into a binding agreement to resolve any "matter" involving a trust or an estate. The term "matter" is defined very broadly and includes construction of wills and trusts and the grant to a trustee of any necessary or desirable power. If the agreement is filed with the proper court, it is deemed approved by the court and is equivalent to a final court order having binding effect on all interested persons.

C. Trust Decanting

The term "decanting," when used in the context of trust administration, refers to a transaction whereby a Trustee exercises discretionary distribution authority set forth in an existing trust instrument by distributing not outright to the beneficiary to or for whom the Trustee is empowered to distribute but, rather, to a new trust for the benefit of the target beneficiary and perhaps one or more others.[12] "Decanting" may also refer to a modification of a trust instrument,

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[8] In a general sense, similar to pre-UTC law but broader in that UTC § 412(a) applies to dispositive, as well as administrative, terms and requires that modification or termination just "further the purposes of the trust" rather than avoid defeat or substantial impairment of accomplishment of the purposes of the trust. *See* RESTATEMENT (SECOND) OF TRUSTS (1959) § 167.

[9] *See* 5A Austin Wakeman Scott, William Franklin Fratcher & Mark L. Ascher, SCOTT AND ASCHER ON TRUSTS, Section 615 (5th ed. 2008).

[10] *See*, *e.g.*, Alaska Stat. § 13.36.157(b).

[11] Idaho Stat. §§ 15-8-101 to 15-8-103; Rev. Code Wash. §§ 11.96A.010 to 11.96A.902.

[12] Uniform Trust Decanting Act, Section 2(10). The Uniform Trust Decanting Act has been introduced in Massachusetts and has been enacted in Alabama, California, Colorado, Illinois, Maine, Montana, Nebraska, New Mexico, North Carolina, Virginia, Washington, West Virginia. For statutory citations, *see note* 17.

carried out unilaterally by the Trustee, having fundamentally the same end result as a decanting without actually moving trust property to a new trust.[13] Whether a Trustee distributes to a new trust or modifies the governing instrument of an existing trust, the Trustee is performing a function in his, her or its fiduciary capacity.[14]

Decanting is a trust law concept that has developed widely only in very recent years. Although the idea was introduced by the Supreme Court of Florida in 1940,[15] its spread has been facilitated by the enactment of statutes explicitly authorizing decanting in thirty states, all but two of which[16] have been enacted within the last twenty years.[17]

Numerous objectives may be achieved by decanting a trust. The Trustee may desire merely to implement innocuous changes that relate solely to the mechanics of trust administration or involve clarifying ambiguous language or correcting errors in the governing instrument. Depending on the features of a given state's decanting law, a Trustee may also have the latitude, when decanting, to introduce different standards for distribution, permit or direct distributions at a different time or times, create new powers of appointment and add or remove beneficiaries. Some statutes specify that a decanting may be completed whether or not there is a current need to distribute principal or income to a beneficiary.[18]

D. Modification and Decanting Fundamentally Different

1. *Modification*

Trust modification, whether carried out independently by the beneficiaries, in cases in which that's possible, or ultimately implemented by a court order, is analogous to trust decanting only in a very superficial way. While the end result, *i.e.*, changes to an irrevocable trust's terms, may be the same, the risks undertaken, and the party or parties assuming risk, are quite different. A modification generally doesn't require the active participation or approval of the Trustee, and so the Trustee's fiduciary duties aren't implicated. Whether the beneficiaries, acting in their respective individual capacities, proceed based on good or bad motives is rarely, if ever, an issue in trust modification because the beneficiaries, as such, owe fiduciary duties to no one. Thus, there is no realistic potential for a breach of fiduciary duty claim to arise in the case of a modification.

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[13] *Id*.
[14] Uniform Trust Decanting Act, Section 4.
[15] *See Phipps v. Palm Beach Trust Company*, 196 So. 299, 142 Fla. 782 (1940).
[16] New York's and Alaska's.
[17] Ala. Code § 19-3D-1, *et seq*., Alaska Stat. §§ 13.36.157 to 13.36.159, Ariz. Rev. Stat. § 14-10819, Cal. Prob. Code §19501 *et seq*., Colo. Rev. Stat. § 15-16-901 *et seq*., Del. Code tit. 12 § 3528, Fla. Stat. § 736.04117, Ga. Code §53-12-62, 760 ILCS 3/1201 through 3/1227, Ind. Code § 30-4-3-3, Ky. Rev. Stat. § 386.175, Mich. Comp. Laws §§ 556.115a and 700.7820a, Minn. Stat. § 502.851, § 456.4-419, RSMo., Nev. Rev. Stat. § 163.556, N.H. Rev. Stat. § 564-B:4-418, N.M. Stat. § 46-12-101, *et seq.*, N.Y. Cons. Est. Powers and Trusts Law § 10-6.6, N.C. Gen. Stat. §§ 36C-8B-1 to 36C-8B-30, N.D. Cent. Code § 59-16.1-01, *et seq*., Ohio Rev. Code § 5808.18, R.I. Gen. Laws § 18-4-31, S.C. Code § 62-7-816A, S.D. Codified Laws §§ 55-2-15 to 55-2-21, Tenn. Code § 35-15-816(b)(27), Tex. Prop. Code §§ 112.071 to 112.087, Va. Code § 64.2-779, Rev. Code Wash. §§ 11.107.010 to 11.107.080, Wis. Stat. § 701.0418, Wyo. Stat. § 4-10-816(a)(xxviii) & (b).
[18] *See, e.g.*, N.C. Gen. Stat. § 36C-8B-21.

The actors in a modification do need to be vigilant, however, to ensure that a few essential details are addressed. First, it is imperative that **all** beneficiaries,[19] without exception, are validly participating, whether actually or by means of virtual representation.[20] Second, any beneficiary seeking virtually to represent another beneficiary must not have a conflict of interest with that other beneficiary. Third, if proceeding under UTC § 111 or UTC § 411(b), the modification must not violate or be inconsistent with a material purpose of the trust.[21]

2. *Decanting*

a. Discretionary Act

Trust decanting, on the other hand, is carried out solely by the Trustee. Decanting is inherently a discretionary act, and so the Trustee must be attentive to his, her or its fiduciary duties largely in the same way and to the same extent as when a Trustee makes a more conventional discretionary distribution.[22] In particular, in a case in which decanting is being effectuated to make changes to dispositive provisions or to alter beneficial interests, *e.g.*, eliminate one or more beneficiaries, add one or more beneficiaries, confer or remove a power of appointment, the Trustee should strive to do so in a way demonstrating that he, she or it was acting reasonably and mindfully taking into consideration the present and anticipated future needs and circumstances of the beneficiaries of the trust before decanting.

b. *Hodges v. Johnson*

A case starkly illustrating a Trustee's potential exposure to liability in trust decanting is *Hodges v. Johnson*.[23] In *Hodges*, two irrevocable trusts were established in 2004 for the benefit of the grantor's wife, children, other descendants and step-children. The Trustees had a discretionary power to "distribute all or any portion of the net income and principal of the trust to any one or more of the group consisting of [the beneficiaries] and distributee trusts, in such amounts and at such times as the Trustee, in the Trustee's discretion, may determine." "Distributee trusts" were defined as any trust under the trust instruments or any other trust established by the grantor. A distributee trust could be for the benefit of one or more, "but not necessarily all," of the beneficiaries.

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[19] A "beneficiary" is any person who has a present or future beneficial interest in a trust, vested or contingent, or, in a capacity other than that of Trustee, holds a power of appointment over trust property. UTC § 103(3).

[20] Virtual representation, described and codified in Article 3 of the UTC, is the concept that, under prescribed circumstances, a person may represent and bind another person. The representation provisions of Article 3 apply to all trust matters including, but not limited to, active litigation, routine matters (such as providing notices to trust beneficiaries) and non-litigated matters (such as nonjudicial settlement agreements and certain trust modifications).

[21] It should be noted, however, that, depending on a particular state's law regarding what constitutes a "material purpose of the trust," this requirement may amount to little more than a speed bump. *See*, *e.g.*, KS Stat § 58a-411(c), which states: "A spendthrift provision in the terms of the trust is not presumed to constitute a material purpose of the trust."

[22] Ordinarily, a Trustee's failure to make a discretionary distribution has the potential to constitute a breach of fiduciary duty. To relieve Trustees from potential liability for not decanting, some decanting statutes specify that a Trustee is under no duty to complete a decanting. *See, e.g.*, Ohio Rev. Code § 5808.18(J); Ind. Code § 30-4-3-36(f); Section 456.4-419.5, RSMo.; N.H. Rev. Stat. § 564-B:4-418(o).

[23] *Hodges v. Johnson*, 177 A.3d 86 (N.H. 2017).

The Trustees of the two irrevocable trusts signed documents ostensibly decanting the trusts' assets to new trusts. The governing instruments of the new trusts omitted the grantor's two step-children and one of his biological children from the definition of "descendants," effectively stripping their interests in the trusts. The decanting documents provided for the transfer of the assets of the original trusts to the new trusts upon the grantor's death, and so the assets of the original trusts were not transferred to the new trusts contemporaneously with the signing of the decanting documents. Both the trial court and the Supreme Court of New Hampshire treated the decantings as if they had occurred when decanting documents were executed and as if the failure promptly to transfer the assets didn't render the decantings invalid.

Under New Hampshire's decanting statute in effect when the decantings occurred, and now, if a Trustee of a trust has the power to make discretionary distributions of principal to one or more beneficiaries, the Trustee may decant the assets of that trust to another trust "for the benefit of one or more" of the beneficiaries of the original trust[24] (obviously implying that, at least in some circumstances, one or more beneficiaries of the original trust may be excluded as beneficiaries of the new trust).

The trial court set aside the decantings and removed the Trustees. On appeal, the Supreme Court of New Hampshire held that, even though New Hampshire's decanting statute allowed the Trustees to eliminate beneficiaries, and even though the Trustees were permitted to distribute income and principal in their discretion, they were nevertheless subject to the duty of impartiality in carrying out the decanting. The New Hampshire Supreme Court stated that "a trustee, who makes unequal distributions among beneficiaries and/or eliminates a beneficiary's non-vested interest in an irrevocable trust through decanting, violates the statutory duty of impartiality [] when the trustee fails to treat the beneficiaries 'equitably in light of the purposes and terms of the trust.'"[25] The Supreme Court of New Hampshire noted favorably the trial court's finding that, in decanting, the Trustees failed to consider the interests of all of the beneficiaries, present or remainder, vested or contingent. Despite the seemingly plain language of New Hampshire's decanting statute, the New Hampshire Supreme Court opined it would be "difficult to imagine the factual scenario where the trustee would not violate its fiduciary duty of impartiality owed to that [eliminated] beneficiary."

A Trustee contemplating decanting might consider seeking consents from as many beneficiaries as possible, but, since decanting is fundamentally a discretionary principal distribution, it is arguable a conscientious Trustee should be prepared to proceed without consents as with any discretionary principal distribution.[26]

In any event, a decanting Trustee should strive mightily to ensure the decanting does not stray from the parameters of the applicable decanting statute.[27]

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[24] N.H. Rev. Stat. § 564-B:4-418(a).

[25] Quoting UTC § 803 cmt.

[26] Such an argument may carry less weight in jurisdictions (including New Hampshire) whose decanting statutes absolve a Trustee from any duty to engage in decanting. *See* note 22.

[27] *See, e.g.*, *In re Petition of Johnson*, 2015 N.Y. Misc. LEXIS 51 (N.Y. Surr. 2015) (upon complaint by beneficiary, decanting invalidated by court because the decanting resulted in the addition of beneficiaries of the new trust in violation of the New York decanting statute).

IV. POSSIBLE TAX CONSEQUENCES OF CHANGING OR TERMINATING IRREVOCABLE TRUSTS

A. Income Tax – Private Letter Ruling 201932001

Private Letter Ruling ("PLR") 201932001[28] responds to the requests of the Co-Trustees of an irrevocable trust that the Internal Revenue Service ("IRS") rule on the gift, generation-skipping transfer and income tax consequences of a proposed premature termination of the trust. The IRS' conclusions regarding the gift and GST tax results that would flow from the proposed trust termination are as would be expected and wholly uninteresting. The income tax analysis is another story.

1. *Facts*

The trust instrument conferred on the settlor's son ("Son") a mandatory income interest for his life. At his death, his descendants were to receive the remainder. No distributions of principal were allowed during Son's life. A relevant state statute allowed termination of an irrevocable trust pursuant to a nonjudicial settlement agreement ("NJSA"), with court approval, if the court concluded continuance of the trust was no longer required to achieve any material purpose of the trust.[29] Son, the then living remainder beneficiaries who would take if the trust were then to terminate by its terms (the Current Remaindermen) and the then living remainder beneficiaries who would take if the trust were then to terminate by its terms and none of the Current Remaindermen were then living (the Successor Remaindermen) all entered into an NJSA, presumably compliant with the statute, providing for immediate termination of the trust and distribution of all trust property among Son, the Current Remaindermen and the Successor Remaindermen in accordance with their respective actuarial interests in the trust. Under the NJSA, the Trustees were to effectuate distribution among the distributees, in their sole discretion, "on a pro rata or in kind basis."[30]

2. *Analysis*

The IRS ruled that the termination distributions were, in substance, a sale of Son's and the Successor Remaindermen's beneficial interests to the Current Remaindermen giving rise to long-term capital gain treatment for Son and the Successor Remaindermen under IRC Section 1222(3).[31] This is the income tax ruling the Co-Trustees requested.

Note that Son, the Current Remaindermen and the Successor Remaindermen all received amounts equal to their actuarial interests in the trust. Son and the Successor Remaindermen didn't convey, by sale or otherwise, anything at all to the Current Remaindermen.[32]

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[28] Dated April 9, 2019 and released August 9, 2019. There were actually ten virtually identical rulings. Private Letter Rulings 201932001-010.

[29] Undoubtedly, an iteration of UTC §411(b).

[30] A distribution of trust assets "pro rata" is generally understood to entail division and distribution of each asset, insofar as possible, on a percentage basis among the recipients based on the relative values of their respective interests in the trust.

[31] All references to "IRC" are to the Internal Revenue Code of 1986, as amended.

[32] The Internal Revenue Service ("IRS") explicitly acknowledged this fact in the gift tax ruling portion of Private Letter Ruling ("PLR") 201932001: "[W]e conclude that no transfer of property will be deemed to occur as a result of the termination and Proposed Distribution."

All the trust's beneficiaries received nothing more and nothing less than the true value of their respective interests. The possession of their interests was accelerated, but no value was shifted among them.

Rev. Rul. 72-243[33] and *McAllister*,[34] cited and discussed in PLR 201932001, would appear to support the conclusion that the amounts received by Son and the Successor Remaindermen were amounts received from the sale or exchange of a capital asset. It seems curious that, in Rev. Rul. 72-243 and *McAllister*, as in PLR 201932001, all involving premature trust terminations, the taxpayers apparently conceded without a whimper that the lump sum distributions to the life tenants/income beneficiaries were taxable sales or exchanges instead of arguing there was no sale, exchange or transfer of any kind. Rev. Rul. 72-243, *McAllister* and PLR 201932001 all hang on the demonstrably incorrect proposition that the life tenant/income beneficiary received his or her distribution ***in exchange for*** the transfer of his or her beneficial interest to the remainder beneficiaries.

Rev. Rul. 69-486,[35] also cited and discussed in PLR 201932001, holds that a non-pro rata distribution of trust property, where neither the trust instrument nor local law allows the Trustee to make a non-pro rata distribution, was equivalent to a pro rata distribution followed by an exchange between the beneficiaries, an exchange that required recognition of gain under IRC Section 1001. No facts are recited in PLR 201932001, however, that would bring it within the purview of Rev. Rul. 69-486. PLR 201932001 contains nothing to suggest that the Trustees actually made non-pro rata distributions. The NJSA said the Trustees had discretion to distribute "on a pro rata or in kind basis,"[36] but the Trustees may well have made ratable distributions among all beneficiaries. To the extent ratable distributions were made, Rev. Rul. 69-486 has no application. In addition, the trust instrument and/or local law may have allowed for the making of non-pro rata distributions. If so, Rev. Rul. 69-486 is easily distinguishable on that ground alone.

It has been suggested that the income tax conclusion in PLR 201932001 is supportable on the theory that, on termination of the trust and distribution of its assets among the beneficiaries in accordance with their respective actuarial interests, they received something "materially different," within the meaning of *Cottage Savings*[37] and Treas. Reg. Section 1.1001-1(a), from what they possessed before such termination and distribution. This argument is not persuasive. First, the IRS, presumably well aware of *Cottage Savings*, didn't mention or cite it in PLR 201932001, and didn't say anything in PLR 201932001 about "material differences," and so it would seem the IRS didn't think *Cottage Savings* applied. In fact, in the gift tax portion of the ruling, the IRS as much as concedes the point:

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[33] Rev. Rul. 72-243, 1972-1 C.B. 233.
[34] *McAllister v. Commissioner*, 157 F.2d 235 (2d Cir. 1946).
[35] Rev. Rul. 69-486, 1969-2 C.B. 159.
[36] The meaning of this phrase is indecipherable. A distribution of trust assets "in kind" is a distribution of trust assets themselves as opposed to a distribution of proceeds from a pre-distribution sale of assets. Thus, "in kind" is not an alternative to or the opposite of "pro rata." In fact, the only way to make pro rata distributions is to make in kind distributions.
[37] *Cottage Savings Association v. Commissioner*, 499 U.S. 554, 111 S. Ct. 1503, 113 L. Ed. 2d 589, 1991 U.S. LEXIS 2224 (1991).

> In the present case, the beneficial interests, rights, and expectancies of the beneficiaries will be substantially the same, both before and after the termination and Proposed Distribution, as long as the actuarial values of the trust accurately represent the actuarial value of each beneficiary's interest.

Second, *Cottage Savings* involved facts "materially different" from the facts of PLR 201932001. *Cottage Savings* addressed an exchange of mortgage participation interests – hardly comparable to beneficial interests in a trust. Although the values of the exchanged mortgage participation interests were equal, the underlying substance of the interests was not at all the same because, after the exchanges, the parties ended up having security interests in different properties. By contrast, in PLR 201932001, no facts are recited to indicate the beneficiaries ended up with interests in different trust assets than the trust assets in which they had interests before trust termination.

B. Gift Tax

1. *Commutation of QTIP Trust*

Engineering the premature termination of a QTIP trust[38] is particularly tricky. Chief Counsel Advice 202118008 (May 6, 2021) illustrates the point well. A decedent's surviving spouse ("Spouse"), was beneficiary for life of a typical QTIP trust, was entitled to receive the trust's entire net income, at least annually, and had the potential to receive discretionary principal distributions in accordance with an ascertainable standard. Spouse had a testamentary nongeneral power of appointment that could be exercised in favor of the decedent's descendants. Unappointed trust property was to pass at Spouse's death to the decedent's children, by right of representation.

Spouse and the children (the children representing themselves and virtually representing the contingent remainder beneficiaries) entered into an agreement whereby the QTIP trust was terminated, and all trust property was distributed to Spouse.

The following issues were presented and resolved as follows:

- Termination of the QTIP trust was a disposition of Spouse's qualifying income interest within the meaning of IRC Section 2519(a). Spouse was therefore treated under IRC Section 2519(a) as having made a gift of the entire trust property other than the qualifying income interest.

- Distribution of all the QTIP trust's assets to Spouse was treated as a gift by the remainder beneficiaries under IRC Section 2511.

- Spouse's deemed gift under IRC Section 2519(a) and the remainder beneficiaries' gift to Spouse under IRC Section 2511 were separate gifts that do not offset each other.

[38] A trust holding "qualified terminable interest property." *See* IRC Section§ 2056(b)(7)(B) and 2523(f)(2).

- The value of Spouse's deemed gift under IRC Section 2519(a) was the fair market value of the entire property of the QTIP trust minus the then present value, determined under IRC Section 7520, of Spouse's qualifying income interest. Following the language of IRC Section 2519(a), the IRS concluded the possibilities that Spouse could have received discretionary principal distributions and/or exercised the nongeneral power of appointment should be ignored for purposes of valuing Spouse's deemed gift.

- The children had determined the value of their gifts to Spouse to be $0.00. The IRS disagreed and determined the value of the remainder beneficiaries' gifts under IRC Section 2511 to be the then present value, determined under IRC Section 7520, of their remainder interest. In performing the valuation (since neither the Trustee of the QTIP trust nor the children had done so), the IRS disregarded any possibility that Spouse, had the QTIP trust not been commuted, would have received any discretionary principal distributions or exercised the nongeneral power of appointment.

2. *Modification or Termination*

When trust beneficiaries come together to modify a trust for the purpose of making changes that are purely administrative, clarifying or corrective, gift tax consequences generally shouldn't result. On the other hand, a trust modification by beneficiaries[39] that alters or shifts beneficial interests, or that sets up the possibility that beneficial interests will be altered or shifted, or a premature termination of a trust by its beneficiaries, may constitute a current gift or a gift in the future.

a. <u>Overarching Principle</u>

Lest there be any doubt that a trust modification that alters or shifts beneficial interests may give rise to a taxable gift, Treas. Reg. Section 26.2601-1(b)(4)(i)(E), *Example 7*, should nullify that doubt. In the example, A, B, and C are to receive equal shares of the income of a trust during their lives. At the death of the first of them to die, one-third of the trust property is to be distributed to his or her descendants. At the death of the second of them to die, one-half of the trust property is to be distributed to his or her descendants. At the death of the last of them to die, all remaining trust property is to be distributed to his or her descendants. The Trustee, with the consent of B and C, petitioned the appropriate local court, and the court approved a modification of the trust that increased A's share of trust income. The IRS concluded that, although the modification would not subject the trust to the provisions of Chapter 13 of the Internal Revenue Code,[40] it would be a transfer by B and C to A for federal gift tax purposes.

[39] The fact that court action may be required to effectuate a modification (or termination) driven by the beneficiaries does not obviate the possibility that tax consequences will ensue. *See*, *e.g.*, PLR 201932001, *supra*, *note* 28.
[40] All references to the "Internal Revenue Code" are to the Internal Revenue Code of 1986, as amended.

b. Modification or Termination as Exercise of General Power of Appointment

Modification or termination of a trust by beneficiaries in a way that changes or sets up changes to their beneficial interests may be viewed as their exercising a power of appointment. Whether such exercise by a given beneficiary amounts to a taxable transfer by him or her would seem to hang on whether the power is a general power of appointment as defined in IRC Section 2514(c). The general rule of IRC Section 2514(c) is that a power is a general power of appointment if it is exercisable in favor of the powerholder, his or her estate or the creditors of either.[41] A power exercisable by a trust beneficiary to modify or terminate a trust in favor of him or herself is a power within the parameters of the general rule. There are significant exceptions to the general rule, however, rendering a power not a general power of appointment in the following circumstances:

- Where the power is limited to an ascertainable standard relating to the powerholder's health, education, maintenance or support;[42]

- Where the power is exercisable only in conjunction with the creator of the power;[43] or

- Where the power is exercisable only in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to exercise in favor of the powerholder.[44] Regarding whether an interest is adverse to the exercise of a power, and whether such an interest is "substantial," the applicable Treasury Regulation provides as follows:

> An interest adverse to the exercise of a power is considered as substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, the interest is to be valued in accordance with the actuarial principles set forth in § 25.2512-5 or, if it is not susceptible to valuation under those provisions, in accordance with the general principles set forth in § 25.2512-5. A taker in default of appointment under a power has an interest which is adverse to an exercise of the power. A coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power. However, a coholder of a power is considered as having an adverse interest where he may possess the power after the possessor's death

[41] Treas. Reg. § 25.2514-1(c).
[42] IRC Section 2514(c)(1).
[43] IRC Section 2514(c)(3)(A); Treas. Reg. § 25.2514-3(b)(1).
[44] IRC Section 2514(c)(3)(B); Treas. Reg. § 25.2514-3(b)(2).

> and may exercise it at that time in favor of himself, his estate, his creditors, or the creditors of his estate.[45]

The examples immediately following the text of Treas. Reg. § 25.2514-3(b)(2) help to explicate who is an adverse party for purposes of IRC Section 2514(c)(3), although they do not elucidate whether an interest is "substantial." The following principles can be distilled from the examples:

- A remainder beneficiary's interest is adverse to the exercise of a power in favor of the beneficiary for life.[46]
- The interest of a beneficiary for life is adverse to the exercise of a power in favor of the remainder beneficiary.[47]
- The interest of a beneficiary for life is not adverse to the exercise of a power in favor of the remainder beneficiary if, following the death of the beneficiary for life, the Trustees can designate an alternate remainder beneficiary.[48]

The examples don't make clear whether, for such adversity to exist, the remainder beneficiary's interest must be vested or may be contingent.

In a case in which the power is exercisable only in conjunction with another person but is, under the preceding summarized rules, nevertheless a general power of appointment, the powerholder is treated as holding the power to the extent of a share of the property subject to the power determined by a fraction the numerator of which is 1 and the denominator of which is the sum of the number of persons (including the powerholder) who must come together to effectuate an exercise of the power.[49]

c. <u>Conclusions</u>

While it is not difficult to imagine cases in which a beneficiary, by participating in a trust modification or termination, is involved in the relinquishment of a beneficial interest in the trust, determining when the IRS or a federal court would perceive that a taxable gift has been made will often be exceedingly difficult. As reflected above, there is not a lot of guidance regarding what constitutes an interest "which is adverse to the exercise of the power," and even less guidance as to what is meant by "substantial interest in the property subject to the power," for purposes of IRC Section 2514(c)(3).

The following examples illustrate the uncertainties:

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[45] Treas. Reg. § 25.2514-3(b)(2).
[46] Treas. Reg. § 25.2514-3(b)(2), *Example (1)*.
[47] Treas. Reg. § 25.2514-3(b)(2), *Example (2)*.
[48] Treas. Reg. § 25.2514-3(b)(2), *Example (3)*.
[49] IRC Section 2514(c)(3)(C); Treas. Reg. § 25.2514-3(b)(3).

- If X, Y and Z, beneficiaries of a trust, hold a power jointly under applicable state law to modify the governing instrument or terminate the trust, and, if on X's death Y and Z would succeed to X's power, then Y and Z are considered to have interests adverse to the exercise of the power in favor of X.[50] Assuming Y and Z's interests were considered "substantial," X would not be considered to hold a general power of appointment.

- If X, Y and Z, beneficiaries of a trust, hold a power jointly under applicable state law to modify the governing instrument or terminate the trust, and, if on X's death Y and Z would not succeed to X's power, then Y and Z are not considered to have interests adverse to the exercise of the power in favor of X. In this case, X is considered to possess a general power of appointment as to one-third of the property subject to the power.[51]

- Now suppose X is the sole current beneficiary of a trust for life, Y and Z are first-line contingent remainder beneficiaries, and all other contingent remainder beneficiaries are minors (obviously, a very common fact pattern). X, Y and Z (with Y and Z representing themselves and all other contingent remainder beneficiaries) seek to modify the trust.

    - Are Y and Z's interests in the trust sufficiently adverse to X's participation in the modification or termination to cause that participation not to be the exercise of a general power of appointment within the meaning of IRC Section 2514?

    - Do Y and Z's interests in the trust, for purposes of answering that question, include the interests of those other contingent remainder beneficiaries whom they are representing?

    - Are Y and Z's interests in the trust "substantial"?

    - Do Y and Z's interests in the trust, for purposes of answering that question, include the interests of those other contingent remainder beneficiaries whom they are representing?

3. *Decanting*

Similar to trust modification by beneficiaries, when a Trustee decants to make innocuous, non-dispositive changes to a trust instrument, no one should be treated as having made a gift. A decanting transaction that alters or shifts beneficial interests, however, whether

[50] *Supra*, *note* 45.
[51] Treas. Reg. § 25.2514-3(b)(3).

immediately or in the future, clearly has gift tax implications.[52] Determining when a gift occurs, if at all, and ascertaining the gift's value, could be very challenging.

a. <u>By Interested Trustee</u>

If the Trustee is also a beneficiary (an "interested Trustee"), then, to the extent the interested Trustee decants in a manner that eliminates or reduces the value of his or her beneficial interest, the interested Trustee could be transferring something of value. Treasury Regulations implicitly recognize this possibility:

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee isn't a taxable transfer ***if*** it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument.[53] (Emphasis added.)

Just as within the context of modification, the method by which the interested Trustee could be viewed as implementing a taxable transfer is the exercise of a general power of appointment. Thus, much of the analysis above concerning the circumstances in which a beneficiary participating in a modification may be considered as making a taxable gift is equally applicable to an interested Trustee engaging in decanting.

b. <u>By Independent Trustee</u>

A non-beneficiary Trustee (an "independent Trustee") who implements a decanting that impacts, or in the future may impact, beneficial interests isn't transferring anything of value in which he has "ownership" or a beneficial interest. Such a Trustee can't make a gift of something that isn't his or hers.[54] If, however, a beneficiary whose beneficial interest is diminished or eliminated by the decanting could've sued the Trustee and successfully caused the decanting to be reversed, but instead allows it to stand unchallenged, that beneficiary (an "acquiescing beneficiary") may have made a gift when expiration of the applicable statute of limitations forecloses suing the Trustee.[55]

Whether a gift may occur in such an instance depends on how likely it is that the acquiescing beneficiary could have succeeded in causing the decanting to be reversed.[56] Gift tax consequences should potentially arise only if the acquiescing beneficiary had more than

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[52] Obviously, the Internal Revenue Service has concerns about the possible gift (and other) tax consequences of a decanting that results in a change in a trust's beneficial interests. *See* Notice 2011-101, 2011-52 I.R.B. 932 (December 27, 2011).

[53] Treas. Reg. Section 25.2511-1(g)(2). *See*, *also*, IRC Section 2514(c)(1).

[54] Treas. Reg. Section 25.2511-1(g)(1).

[55] *See* Rev. Rul. 81-264, 1981-2 C.B. 185 (concluding that an individual who permits the statute of limitations to expire on the recovery of a loan to a family member has made a gift if the debtor had some financial resources available to repay the loan).

[56] *See* RESTATEMENT (THIRD) OF TRUSTS (2003) § 50, indicating that an impending transaction by a Trustee may be subject to "judicial control" only if necessary to "prevent misinterpretation or abuse of discretion by the trustee."

the mere ability to object but in fact had a reasonable chance of ***successfully*** objecting to the decanting.[57]

As a strategic matter, obtaining a court order, or entering into a court-approved nonjudicial settlement agreement, binding on all interested parties, authorizing or approving, ***in advance***, a decanting transaction might be considered. Rev. Rul. 73-142, 1973-1 C.B. 205, may be considered solid precedent for the proposition that such a judicially-sanctioned decanting transaction should be recognized for tax purposes as entirely legitimate and not giving rise to a cause of action by the acquiescing beneficiary.

c. <u>Additional Considerations</u>

Not to be overlooked is the very real possibility that, if there is a "gift" by an interested Trustee or an acquiescing beneficiary to a member of his or her family and he or she retains an interest in the trust that isn't a "qualified interest," the value of the gift will be the value of the interested Trustee or acquiescing beneficiary's entire beneficial interest in the trust.[58]

Even if a given decanting transaction doesn't trigger a current gift, it may give rise to an incomplete gift.[59] Determining whether an incomplete gift occurs in a particular instance requires a careful examination of the governing instrument of the trust that resulted from the decanting (the "new trust"). In the new trust, an interested Trustee or an acquiescing beneficiary may possess a power of disposition or a power of appointment over that which he or she relinquished.[60] If such power of disposition is "a fiduciary power limited by a fixed or ascertainable standard," or is exercisable only "in conjunction with any person [] having a substantial adverse interest in the disposition of the transferred property or the income therefrom," it would be insufficient to render the decanting an incomplete gift.[61] Otherwise, the decanting will result in a completed gift if, to the extent and at the time the power is exercised or is no longer capable of being exercised.[62] Completion of the gift may occur many years after the decanting transaction that set up the eventual gift.

Finally, consider whether the exercise of a decanting power, or the acquiescence in the exercise of decanting power, that creates a power of appointment in a new trust that could under applicable law be validly exercised so as to postpone the vesting of any beneficial interest for a period ascertainable without regard to the date on which such beneficial interest originated could constitute a taxable gift to the extent of the value of the property subject to such power.[63] In other words, it may be possible to construe the exercise of a decanting power, or a beneficiary's acquiescence in the exercise of a decanting power, as the exercise of a power of appointment within the meaning of IRC Section 2514(d).

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[57] Also relevant to whether or the extent to which a gift may result in this context are the expected costs of suing the Trustee.
[58] *See* IRC Section 2702.
[59] *See* Treas. Reg. Section 25.2511-2.
[60] *See* Treas. Reg. Section 25.2511-2(b) & (c).
[61] Treas. Reg. Section 25.2511-2(c) & (e).
[62] Treas. Reg. Section 25.2511-2(f).
[63] *See* IRC Section 2514(d) -- commonly known in the estate planning world as the "Delaware Tax Trap."

C. Generation-Skipping Transfer Tax

While there is no provision of the gift tax regulations directly addressing trust modification, premature termination or decanting, a portion of the generation-skipping transfer tax regulations, Treas. Reg. Section 26.2601-1(b)(4)(i)(D), makes abundantly clear that, in the opinion of the IRS, a modification or decanting that shifts a beneficial interest in a trust may have transfer tax consequences.

Treas. Reg. Section 26.2601-1(b)(4)(i)(D)(2) provides that: "a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary [thereby subjecting the trust to the provisions of Chapter 13 of the Internal Revenue Code] if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer."

The term, "modification," when used in Treas. Reg. Section 26.2601-1(b)(4)(i)(D), is clearly intended to include decanting. Treas. Reg. Section 26.2601-1(b)(4)(i)(D)(1) refers to: "[a] modification of the governing instrument of an exempt trust [as] including a trustee distribution, settlement, or construction…by judicial reformation, or nonjudicial reformation that is valid under applicable state law…" Additionally, *Example 1* and *Example 2* within Treas. Reg. Section 26.2601-1(b)(4)(i)(E), although they conclude the provisions of Chapter 13 of the Internal Revenue Code do not apply in the situations described therein, set forth facts postulating decanting.

V. ACHIEVING BALANCE BETWEEN FLEXIBILITY AND CERTAINTY

A. Competing Considerations

How should estate planners today formulate an estate plan in a legal environment in which the concept of irrevocability is so porous? On one hand, it would be unwise and impossible to foreclose the making of any and all changes to an irrevocable trust. On the other hand, most estate planning clients would be shocked to their core to learn that their beneficiaries, with little or no regard for the client's dispositive desires, could launch a frontal assault on the client's carefully considered and crafted estate plan. There are steps that can be taken to prevent or dissuade frivolous or vengeful actions by disgruntled parties and to help ensure a client's carefully constructed estate plan is preserved intact.

B. Possible Approaches

Achieving an appropriate balance between flexibility and certainty in an estate plan is a delicate exercise and varies from one client to another. Following is a list of some possible approaches:

- A client could consider including in his or her Will or trust instrument a strong statement regarding his or her dispositive desires and his or her overriding wish that, notwithstanding what may be possible under applicable state trust law, his or her dispositive plan not be disturbed except in the most compelling of circumstances.

- A client might desire that trust beneficiaries not have power to remove and replace Trustees for no reason and if so could include a statement in his or her Will or trust

instrument prohibiting a decanting, and imploring a court not to allow or sanction a modification, that would confer, or would allow any person to confer, such power on the beneficiaries.[64]

- A client could include an explicit statement in his or her Will or trust instrument regarding the client's "material purposes" (thereby making it more difficult to change provisions that would implement such purposes).

- A client could include "*in terrorem*" language in the Will or trust instrument that would remove as a beneficiary anyone who initiated or participated in any process or proceeding to alter specified provisions or types of provisions.

- Many trust decanting statutes can be used only if the trust's governing instrument does not provide otherwise,[65] so a client who is concerned about the potential for decanting may be able to narrow that potential by including a provision limiting what may be accomplished by means of decanting.

- Although under UTC § 105(b) a court would always have authority to modify or terminate a trust under UTC §§ 410 through 416 regardless of any provision in the governing instrument, a governing instrument could limit or prohibit using a nonjudicial settlement agreement under UTC § 111 to modify a trust without court involvement or transferring the trust's principal place of administration to another state under UTC § 108.

C. Conclusion

Whether any of the prophylactic provisions suggested above should be included in a client's estate planning documents and, if so, specifically how they should be designed may be debatable. Moreover, given the wide variety of state trust laws, whether or to what extent such provisions would be enforceable would have to be considered carefully on a case-by-case basis. What seems beyond debate, however, is that estate planning clients deserve to know of the potential that their estate plans could be turned upside down and what the possible preventative remedies are.

[64] In *In Re Trust Under Agreement of Taylor*, 164 A.3d 1147 (Pa. 2017), the Supreme Court of Pennsylvania refused to permit such a modification, but, in a case involving virtually identical salient facts, *Glass v. Faircloth*, 840 S.E.2d 724 (Ga. App. 2020), the Court of Appeals of Georgia allowed it.

[65] *See*, *e.g.*, Del. Code tit. 12, § 3528(a); Section 456.4-419.1, RSMo.; Alaska Stat. § 13.36.157.