MODIFYING IRREVOCABLE TRUSTS

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I. INTRODUCTION.

Supposedly irrevocable trusts must sometimes be modified or even terminated due to changed or unanticipated circumstances. While the terms of an irrevocable trust may seem to limit the options of the trustee, statutory and common law allow the terms of expressly irrevocable trusts to be amended under many circumstances. Similarly, merger of an old trust with a new trust having more favorable terms, or decanting of an old trust into a new trust, may effectively result in the modification of the old trust. These laws and strategies provide much more flexibility in the administration of an irrevocable trust than one might otherwise assume.

Part II of this article will examine the substantive methods available to persons desiring to amend an irrevocable trust, including judicial modification, merger of trusts, the sale of trust assets to new trusts, and decanting trusts. Part III of the article will focus on federal income and transfer tax issues that must be considered when contemplating the modification of an irrevocable trust.

II. LEGAL CONSIDERATIONS.

The governing instrument of an irrevocable trust may include provisions specifically addressing the modification of certain terms of the trust. However, several laws and strategies allow the modification of an irrevocable trust where the trust agreement is otherwise silent on the issue.

A. <u>Texas Trust Code Provisions on Modification or Reformation of Trusts.</u>

Under the common law doctrine of equitable deviation, a court may authorize the trustee to deviate from the terms of a trust if, under circumstances not known to or anticipated by the settlor, compliance would defeat the purposes of the trust. *See* Restatement (Second) of Trusts § 167 (1959). The Texas Trust Code codifies the doctrine of equitable deviation by providing for judicial modification of trusts under certain circumstances.

Section 112.054 of the Texas Trust Code allows a court to "order that the trustee be changed, that the terms of the trust be modified, that the trustee be directed or permitted to do acts that are not authorized or that are forbidden by the terms of the trust, that the trustee be prohibited from performing acts required by the terms of the trust, or that the trust be terminated in whole or in part" under any of the following circumstances:

1. The purposes of the trust have been fulfilled or have become illegal or impossible to fulfill;

2. Because of circumstances not known to or anticipated by the settlor, the order will further the purposes of the trust;

3. Modification of administrative, nondispositive terms of the trust is necessary or appropriate to prevent waste or avoid impairment of the trust's administration;

4. The order is necessary or appropriate to achieve the settlor's tax objectives or to qualify a distributee for government benefits and is not contrary to the settlor's intentions;

5. Continuance of the trust is not necessary to achieve any material purpose of the trust and the beneficiaries have consented to, or are deemed to have consented to, the order; or

6. The order is not inconsistent with a material purpose of the trust and the beneficiaries have consented to, or are deemed to have consented to, the order.

Tex. Prop. Code. § 112.054(a). In addition, a trust may be "reformed" for some of the same reasons, or to "correct a scrivener's error in the governing document, even if unambiguous, to conform the terms to the settlor's intentions" if those intentions are established by clear and convincing evidence. *Id.* § 112.054(b-1), (e). (Modification is generally prospective, while reformation may affect how a trust is construed from its inception. For ease of discussion this outline will sometimes use the word "modification" to refer to both types of changes.) The statute further requires the court, in ordering a modification, reformation, or termination described above, to conform "as nearly as possible to the probable intention of the settlor." *Id.* § 112.054(b).

The Restatement (Second) of Trusts gives an example of a trust whose purposes have become impossible to fulfill: the trust was created to provide for the maintenance of a house and the house is destroyed by fire. *See* Restatement (Second) of Trusts § 335, cmt. a (1959). The Restatement also describes unforeseen circumstances that may require modification or termination of a trust, such as changes in the law or the economic environment. *See id.* § 167, cmt. a. Common examples of modifications to achieve tax objectives include the revision of split-interest trusts to qualify for an income, gift, or estate tax charitable deduction and the division of a trust for generation-skipping transfer tax purposes.

Texas law also permits the termination of a trust that has become uneconomical to maintain due to its small size. Section 112.059 of the Texas Trust Code provides that, after providing notice to certain beneficiaries, the trustee of a trust having property valued less than $50,000 may terminate the trust "if the trustee concludes after considering the purpose of the trust and the nature of the trust assets that the value of the trust property is insufficient to justify the continued cost of administration." Tex. Prop. Code. § 112.059(a). The statute provides that upon termination, the trustee shall distribute the trust property in a manner consistent with the purposes of the trust. *Id.* § 112.059(b).

B. Merger of Trusts.

If the trust instrument has problematic administrative terms but is acceptable in substance, the trustee may avoid the expense of seeking a judicial modification by combining the trust with another trust having similar substantive terms but with different administrative provisions.

Section 112.057 of the Texas Trust Code was amended in 2005 to give trustees broader authority (without judicial intervention) to divide and merge trusts. Prior to the 2005 amendment, the Trust Code authorized a trustee to merge trusts only if the trusts had "identical terms" and only if the trustee determined that the merger would result in significant tax savings. *See* former Tex. Prop. Code § 112.057(c) (West 2004). In 2005, the legislature adopted language based on the Uniform Trust Code, which gives the trustee significantly broader authority to merge trusts "for any reason, as long as the rights of the beneficiaries are not impaired and the achievement of trust purposes is not adversely affected." Tex. Prop. Code § 112.057 (State Bar commentary).

The statute now requires that the trustee show the merger "does not impair the rights of any beneficiary or adversely affect achievement of the purposes of one of the separate trusts." *Id.* § 112.057(c). The Trust Code does not define what is meant by impairing the rights of any beneficiary, although the commentary to the Uniform Trust Code provides insight into what the drafters of the uniform law intended by this provision. The commentary elaborates,

> Typically the trusts to be combined will have been created by different members of the same family and will vary on only insignificant details, such as the presence of different perpetuities savings periods. The more the dispositive provisions of the trusts to be combined differ from each other the more likely it is that a combination would impair some beneficiary's interest, hence the less likely that the combination can be approved.

7C Unif. Laws. Ann. (Unif. Trust Code) § 417 comment (2006).

If the trustee determines that he may proceed with a merger, he may do so without the consent of the beneficiaries, *see id.*, but he must give notice of the merger to the beneficiaries not later than thirty days prior to the effective date of the merger unless the beneficiaries waive such notice in writing. Texas Prop. Code Ann. § 112.057(c)(1), (e).

C. Sale to New Trust.

Another option is for the settlor to create a new trust having different terms, and then encourage the trustee of the old trust to sell its assets to the new trust. This technique is often used in the context of irrevocable life insurance trusts. For example, an irrevocable life insurance trust that does not incorporate generation-skipping planning might sell the life insurance policy owned by the trust to a new trust having the desired generation-skipping provisions. The old trust might then be terminated through discretionary distributions of the cash received from the sale to the beneficiaries.

The question in this context typically is not whether the trustee of the old trust has authority to sell its assets, but whether the trustee is properly exercising that authority. Under the general prudent investor rule codified in the Texas Trust Code, the trustee must exercise reasonable care, skill, and caution, "as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust." Tex. Prop. Code § 117.004(a). Particularly with respect to the sale of trust assets, the trustee must "exercise such care and skill as a person of ordinary prudence would exercise," and therefore cannot properly make a sale for "an unreasonably low price or on unreasonable terms." Restatement (Second) Trusts § 190 cmt. i (1959). In determining whether a trustee has satisfied his fiduciary obligations, the terms of the sale may not be as important as the process employed by the trustee to establish those terms. *See* Bogert & Bogert, Trusts & Trustees, § 745 n. 39 (and cases cited therein) (2d ed. 1982).

In *Allard v. Pacific National Bank*, 663 P.2d 104 (Wash. 1989), the court held that a trustee must attempt to obtain the highest possible price in the sale of a trust asset, either by soliciting bids or by obtaining an appraisal of the asset from an independent, qualified appraiser. 663 P.2d at 111; *see Webb & Knapp, Inc. v. Hanover Bank*, 133 A.2d 450 (Md. 1957) (refusing to ratify a trustee's sale for failure to obtain a current appraisal of the property prior to sale). Of course, that may not be practical when selling an asset of modest value.

In the context of the sale of a life insurance policy by an irrevocable life insurance trust, the "transfer for value" rule under Section 101(a)(2) of the Code must be considered. The "transfer for value" rule provides that the purchaser of a life insurance contract will ultimately be taxed on the death benefit it receives unless certain exceptions apply. I.R.C. § 101(a)(2). An exception under Section 101(a)(2)(A) of the Code applies when the policy has a basis for determining gain or loss in the hands of the transferee determined in whole or in part by reference to such basis in the hands of the transferor. Section 101(a)(2)(B) provides an exception where the transfer is "to the insured, a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer."

If the newly created purchasing trust is structured as a grantor trust in which the insured is the grantor for federal income tax purposes, the exception for transfers "to the insured" in Section 101(a)(2)(B) of the Code arguably may be met. If both the old trust and the new trust are grantor trusts in which the insured is the grantor, the transfer should be disregarded for federal income tax purposes and for purposes of the transfer for value rule. *See, e.g.*, P.L.R. 200120007.

D. <u>Decanting.</u>

Some jurisdictions have enacted statutes allowing the trustee to exercise its authority to make discretionary distributions by distributing trust property into another trust having different terms rather than making the distribution to a beneficiary outright. New York was the first state to enact a decanting statute. Other states that have enacted decanting statutes include Alaska, Delaware, Florida, South Dakota and Tennessee. Finally and most importantly, Texas adopted a decanting statute in 2013.

Assuming a statutory or common law decanting is available, the trustee must also carefully consider the potential federal tax consequences of a distribution to a new trust. *See* Section III, *infra*.

1. Common Law Decanting.

The decanting statutes arguably just codify a common law doctrine. Commentators have suggested that trustees who do not wish to make outright distributions to their beneficiaries may use discretionary principal invasion powers to make a distribution of all of the trust corpus to a new trust for the beneficiary. *See* Charles Fox & Thomas Abendroth, *Outright Does Not Always Mean Outright*, ABA Trust & Investments 6, 11 (Jan/Feb 2006). One commentator writes that, "at least in those jurisdictions which have considered the issue, it appears that a trustee, who is not a beneficiary, but who holds a power of 'invasion' over corpus, at least in certain circumstances, may be able to exercise such power of invasion by direction that the property be held in further trust." Jonathan Blattmachr, *Getting it Clean and Keeping it Clean (Another Generation-Skipping Adventure)*, 49 N.Y.U. Ann. Inst. Fed. Tax'n § 8.05[1][a] (1990).

All of these commentators cite the decision of the Florida Supreme Court in *Phipps v. Palm Beach Trust Company*, 196 So. 299 (Fla. 1940), as authority for this proposition. In *Phipps*, the trust instrument provided that at "any time within the duration of this trust . . . upon the written direction of the then Individual Trustee, the Trustees shall pay over and transfer all or any part of the rest, residue, and remainder of the trust estate, both principal and income, . . . to the said [beneficiaries and their descendants] in such shares and proportions as the said Individual Trustee, in his or her sole and absolute discretion, shall determine and fix even to the extent of directing the payment of the entire trust estate to one of said parties." 196 So. at 300. The individual trustee in *Phipps* purported to distribute the entire trust estate to a second trust with slightly different terms.

The court likened the power to distribute corpus under the instrument to a power of appointment and concluded that the "power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent." *Id.* at 301. The court found comfort in the fact that the settlor clothed the trustee with unlimited discretion to make distributions and held that "there can be no question of the power of the individual trustee to create the second trust estate for the benefit of the class named in the original trust indenture." *Id.*

Although the discretion of the trustee in *Phipps* was unlimited, the language of the opinion was quite broad and does not necessarily preclude the same result where the distribution of corpus is limited to the health, education, maintenance and support of the beneficiary. Nevertheless, a New York Surrogate's Court, in a more recent decision, limited the *Phipps* opinion to its facts. In *Estate of Mayer*, 672 N.Y.S.2d 998 (N.Y. Surr. Ct. 1998), the trustee's authority to invade corpus was limited to the health, maintenance, support and education of the beneficiary. The trustee attempted to rely on *Phipps* and the New York decanting statute, but the court refused the trustee's request for approval of the distribution. The court noted that the New York statute authorized such a distribution only if the trustee has "absolute discretion . . . to invade the principal of the trust." 672 N.Y.S.2d at 1000. The court concluded that, although the trustee's exercise of discretion was to be binding and conclusive on all parties, its discretion was nevertheless limited by a standard (health, education, maintenance, and support) and was, therefore, not "absolute." In a footnote, the court cited *Phipps* and limited its holding to those cases in which the trustee's discretion is "unlimited." 672 N.Y.S.2d 1000 n.2.

Regarding the various common law decanting arguments, one commentator notes that "[a]lthough there is support in decided cases for [a common law decanting authority], it can be difficult to demonstrate that this is a particular jurisdiction's common law (especially if dealing with an older trust and the historic law of the jurisdiction). Therefore, a clear grant of authority under a state statute is preferable." Rashad Wareh, *Trust Remodeling*, Trusts & Estates (Aug. 2007).

2. Retention in Trust.

Discussing mandatory distributions of income, the Restatement (Third) of Trusts emphasizes that "if the trustee has good-faith doubt concerning a beneficiary's practical or legal capacity to handle the funds, distributions to which the beneficiary is entitled may be retained and managed by the trustee as a separate fund belonging to the beneficiary, subject to a continuing right of withdrawal upon demand by or on behalf of the beneficiary." Restatement (Third) of Trusts § 49 cmt. c(2) (2003).[1] By extension, the same reasoning should apply to mandatory distributions of corpus.

The Texas Trust Code incorporated this concept in the 2005 legislative session by allowing a trustee who holds property for a beneficiary who is "a minor or a person who in the judgment of the trustee is incapacitated by reason of legal incapacity or physical or mental illness or infirmity," to retain the trust property "as a separate fund on the beneficiary's behalf, subject to the beneficiary's continuing right to withdraw the distribution." Tex. Prop. Code § 113.021(a)(6). This may be thought of as an early, small step toward decanting.

The Texas Trust Code provision is broader than the Restatement provision in that the Trust Code provision applies to both income and principal distributions. The Restatement is broader in that the Restatement provision applies not only in the case of legal or physical incapacity, but also in the case where the trustee has a good faith belief that the beneficiary lacks the practical ability to handle the funds. Both provisions require that the continuation trust give the beneficiary a continuing right of withdrawal.

3. Decanting Statutes of Other States.

As noted above, Texas took a conservative approach toward adopting decanting, taking a baby step in 2005 before adopting much more extensive provisions in 2013. In the meantime, other states experimented with the concept.

The decanting statutes enacted by some of these states (*e.g.* New York) require the trustee to have absolute discretion in order to make a decanting distribution while others (*e.g.* Alaska) do not. The various decanting statutes also differ on who may be a beneficiary of the new trust. For example, Delaware's statute requires that the new trust's beneficiaries be persons to whom the trustee of the old trust could have made discretionary distributions. 12 Del. Code § 3528(a)(1). In contrast, South Dakota's statute provides that the new trust's beneficiaries may be persons who were merely contingent beneficiaries of

[1] This power to retain property in trust for an improvident beneficiary was not incorporated in the Second Restatement of Trusts. *See* Restatement (Second) Trusts § 182 cmt. d (1959).

the first trust. S.D. Laws § 55-2-15. Following is a list of some of the unique provisions of the decanting statutes in New York, Alaska, Delaware, Tennessee, Florida and South Dakota.

a) New York.

New York's decanting statute requires the trustee to have absolute discretion to invade the principal of the trust for the benefit of one or more beneficiaries in order to appoint the principal in favor of another trust. N.Y. Estates, Powers and Trusts Law § 10-6.6(b). The exercise of such discretion must be in favor of the "proper objects of the exercise of" the discretionary distribution power. *Id.* Therefore, the new trust apparently cannot add new beneficiaries, but may exclude some of the current beneficiaries of the old trust.

b) Alaska.

Alaska's decanting statute does not require the trustee's authority to invade principal to be absolute, but the new trust must have the same standard for invading principal as the old trust. Alaska Stat. § 13.36.157. The trustee's power to invade must be for the benefit of a current income beneficiary.

c) Delaware.

Delaware's decanting statute does not require the trustee's authority to invade principal to be absolute and the new trust need not have the same standard for invading principal as the old trust. Del. Code tit. 12, § 3528. The second trust's beneficiaries must be limited to persons who are proper objects of the trustee's power to invade principal. The power cannot be exercised over the portion of a trust that is currently withdrawable by a beneficiary who is the sole trust beneficiary in favor of whom the trustee's invasion power can be exercised. *Id.*

d) Tennessee.

Tennessee's decanting statute does not require the trustee's authority to invade principal to be absolute and the new trust need not have the same standard for invading principal as the old trust. Tenn. Code § 35-15-816(b)(27). Like New York's statute, the exercise of such discretion must be in favor of the "proper objects of the exercise of" the discretionary distribution power. *Id.* Therefore, the new trust apparently cannot add new beneficiaries, but may exclude some of the current beneficiaries of the old trust.

e) Florida.

Florida's decanting statute requires the trustee's authority to invade principal to be absolute. Fla. Stat. § 736.04117. The second trust need not have all the same beneficiaries, but the beneficiaries of the second trust must be persons who were beneficiaries of the first trust. *Id.*

f) South Dakota.

South Dakota's decanting statute does not require the trustee's authority to invade principal to be absolute. S.D. Codified Laws § 55-2-15. The second trust's beneficiaries must be persons to whom a discretionary distribution may be made from the first trust or must be contingent beneficiaries of the first trust. *Id.* The power to decant generally cannot be exercised if the trustee of the first trust is also a beneficiary of the first trust or if any beneficiary may change the trustee of the first trust unless the exercise of the decanting power is for health, education, maintenance or support. *Id.*

4. Decanting in Texas, At Last.

The Texas legislature adopted a broad decanting statute in 2013 and liberalized its provisions in 2017. Tex. Prop. Code §§ 112.071-112.087. The scope of a trustee's authority to distribute the assets of an existing trust to another trust depends on whether the trustee of the first trust has "limited discretion" to distribute principal or "full discretion."

a) Limited Discretion.

A trustee has "limited discretion" if the power to distribute principal involves *no* discretion (e.g., a mandatory income distribution) or the power is limited by an ascertainable standard, including the health, education, support, or maintenance of a beneficiary. Tex. Prop. Code § 112.071(6). If a trustee has only limited discretion to distribute principal, then a decanting distribution can be made only if the new trust has all of the same current and remainder beneficiaries, with the same distribution provisions, and the same powers of appointment (if any). *Id.* § 112.073(b). Thus, administrative provisions may be changed but dispositive provisions may not.

b) Full Discretion.

A trustee has "full discretion" if the trustee's power to distribute principal is not a "limited discretion" power as defined above. Tex. Prop. Code § 112.071(6). For example, the trustee has full discretion if the trustee can distribute principal for a beneficiary's "comfort and well-being," as that power is not limited by an ascertainable standard. (This represents a change from a prior version of the statute, which treated a trustee as having "full discretion" only if the trustee's discretion was absolute.) If a trustee has full discretion to distribute principal, then a decanting distribution can be made if the new trust has one or more (but not necessarily all) of the same current beneficiaries and one or more (but not necessarily all) of the same remainder beneficiaries. *Id.* § 112.072(a). The new trust may not have any additional beneficiaries, but may give beneficiaries the power to appoint trust assets in favor of persons who were not beneficiaries (or permissible appointees) under the original trust. *Id.* § 112.072(b), (c).

c) Divided Discretion.

If the trust has more than one trustee, one with full discretion and one with limited discretion, the trustee with full discretion may decant to a new trust under the more flexible provisions available to such trustees. Tex. Prop. Code § 112.079.

d) Title.

A 2019 addition to the Trust Code clarifies that the trustee may decant "to a trust created under the same trust instrument as the first trust," and in that case, "the property is not required to be retitled." Tex. Prop. Code § 112.0715. This provision may allow decanting to operate more like a modification of the original trust, preserving the same title and perhaps the same taxpayer identification number.

e) Notice.

The trustee must give notice to each current beneficiary and presumptive remainder beneficiary at least 30 days before a proposed decanting distribution. Tex. Prop. Code § 112.074(a), (f)(6). In addition, in some cases the trustee must give notice to the Attorney General with respect to charitable beneficiaries. *Id.* § 112.074(c). The beneficiaries (and Attorney General, where applicable) may waive such notice in writing. *Id.* § 112.074(e-1), (e)(3).

f) Limitations.

The trustee may not make a decanting distribution if the trust agreement expressly prohibits such distributions, or the distribution would:

i) limit a beneficiary's current, vested right to receive certain mandatory distributions;

ii) limit a beneficiary's current, vested right to withdraw a percentage of the trust's value or a specified dollar amount;

iii) materially limit a trustee's fiduciary duty under the terms of the trust, or in a manner that would be prohibited under other provisions of the Trust Code;

iv) add a provision exonerating a trustee from liability, or decreasing or indemnifying against a trustee's liability;

v) eliminate a provision granting a power the right to remove or replace the trustee who makes the decanting distribution; or

vi) modify a perpetuities provision, unless expressly permitted by the terms of the first trust.

Tex. Prop. Code § 112.085. The new trust may, however, "bring the trustee's compensation into conformance with reasonable limits authorized by state law," in connection with a decanting distribution made for another valid and reasonable purpose. *Id.* § 112.087(b).

In addition to the limitations described above, the trustee may not make a decanting distribution that would reduce an exclusion, deduction, or other tax benefit with respect to contributions to the original trust. *Id.* § 112.086(a). However, it appears that the trustee may decant from a trust that is classified as a grantor trust for income tax purposes to a trust that is not so classified, and vice-versa, provided the other requirements for a decanting distribution are satisfied. *Id.* § 112.086(b).

E. <u>Change of Situs.</u>

Sometimes it will not be possible to make a decanting distribution under Texas law (or the law of another state in which the trust is being administered) because of state-specific limitations on such distributions. In that event, the trustee may wish to move the situs of the trust.

Generally, if the settlor designates the law of a state to govern the administration of a trust, that state's law will control. *See* Restatement (Second) of Conflict of Laws §§ 271, 272 (1971); William F. Fratcher, Scott on Trusts, § 612 (4th ed. 1988). However, the trust instrument may have a clause that permits the trustee to change the situs of the trust and its governing law to another jurisdiction. In that case, the trustee might utilize this provision to change the situs to a jurisdiction with more favorable modification or decanting laws.

For example, a trustee desiring to decant a trust but administering the trust under the laws of a state that does not have a specific decanting statute might move the situs of the trust to another state and then utilize that state's decanting statute to distribute the trust assets to a new trust for the benefit of contingent beneficiaries of the trust.

If the settlor has not designated an applicable state to govern the administration of a trust, several factors must be considered, including whether the trust is inter vivos or testamentary, whether the trust assets consist of movables or real property, and whether the trustee is an individual. Regarding the effect of the place of administration on the applicable governing jurisdiction, a leading treatise explains,

> As to the business of administering the trust, it is natural to infer that the settlor intends that the laws of the state of the place of administration shall be applied. This is true, for example, as to the compensation of the trustee, as to the investment of trust funds, and as to the powers and liabilities of the trustee.

William F. Fratcher, Scott on Trusts, § 612 (4th ed. 1989). Generally speaking, a trustee of an inter vivos trust is free to move the trust assets to another state and administer the trust there unless the terms of the trust provide otherwise or unless the trust has become subject to the jurisdiction of a particular court. *Id.* § 613.

III. TAX CONSIDERATIONS.

While modifying an irrevocable trust may be feasible under state law, the trustee must also consider federal income tax and transfer tax issues.

A. <u>Grandfathered GST Trusts.</u>

The federal generation-skipping transfer tax (the "GST Tax") does not apply to generation-skipping transfers under trusts that were irrevocable on September 25, 1985 (a "Grandfathered Trust"). Treas. Reg. § 26.2601-1(b)(1). It is crucial to consider whether a modification to a Grandfathered Trust will cause it to lose its Grandfathered status and be subject to the GST Tax.

Treasury Regulations provide guidance on whether a trust retains its Grandfathered status when certain types of modification occur. Treas. Reg. § 26.2601-1(b)(4). The rules and examples below likely also provide guidance for modifying irrevocable trusts that are not Grandfathered, but have an inclusion ratio of zero for GST Tax purposes because GST exemption was allocated to the trust.

1. <u>Trustee Distributions.</u>

Distribution of trust principal from an exempt trust to a new trust will not cause the new trust to be subject to the GST Tax if the terms of the new trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in the trust property beyond 21 years after the death of the lives in being at the time the trust became irrevocable and if one of the following applies:

1. The terms of the governing instrument of the exempt trust authorize distributions to the new trust, without the consent or approval of any beneficiary or court; or
2. At the time the exempt trust became irrevocable, state law authorized distributions to the new trust without the consent or approval of any beneficiary or court.

Treas. Reg. § 26.2601-1(b)(4)(i)(A). The regulations further provide that a trustee distribution that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in trust property for a term of years that will not exceed 90 years from the time the trust became irrevocable will not be treated as extending beyond the perpetuities period described above.

This safe harbor for distributions to new trusts is particularly applicable in the context of decanting. A decanting distribution that meets the above qualifications will not cause a Grandfathered Trust (or the new trust to which the distribution is made) to lose its exemption from the GST Tax. However, the terms of the particular trust and the state law existing when the trust became irrevocable must be analyzed in order to determine whether the safe harbor under Treas. Reg. § 26.2601-1(b)(4)(i)(A) applies.

The regulations provide an example of the trustee distribution safe harbor:

> In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income or principal to one or more of the group consisting of A, A's spouse or A's issue. Trust will terminate on the death of A, at which time, the trust principal will be distributed to A's issue, per stirpes. Under a state statute enacted after 1980 that is applicable to Trust, a trustee who has the absolute discretion under the terms of a testamentary instrument or irrevocable inter vivos trust agreement to invade the principal of a trust for the benefit of the income beneficiaries of the trust, may exercise the discretion by appointing so much or all of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created, or under the same instrument. The trustee may take the action either with consent of all the persons interested in the trust but without prior court approval, or with court approval, upon notice to all of the parties. The exercise of the discretion, however, must not reduce any fixed income interest of any income beneficiary of the trust and must be in favor of the beneficiaries of the trust. Under state law prior to the enactment of the state statute, the trustee did not have the authority to make distributions in trust. In 2002, the trustee distributes one-half of Trust's principal to a new trust that provides for the payment of trust income to A for life and further provides that, at A's death, one-half of the trust remainder will pass to B or B's issue and one-half of the trust will pass to C or C's issue.

Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 2. The regulations explain that because the state statute was enacted after the original trust was created and requires the consent of all of the parties, the transaction does not meet the discretionary distribution safe harbor. However, the regulation concludes that the transaction will meet another safe harbor (discussed at item 4 below).

2. <u>Settlement.</u>

The regulations also provide a safe harbor for court-approved settlements regarding a bona fide issue as to the administration or construction of a trust if:

1. The settlement is the product of arm's length negotiations; and

2. The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

Treas. Reg. § 26.2601-1(b)(4)(i)(B). The regulations explain that a settlement resulting in a compromise between the positions of the litigating parties and reflecting their assessments of the relative strengths of their positions is "within the reasonable range of outcomes." *Id.*

3. <u>Judicial Construction.</u>

The regulations provide that a judicial construction to resolve an ambiguity in the terms of the trust or to correct a scrivener's error will not cause an irrevocable trust to lose its Grandfathered Status if the judicial action involves a bona fide issue and the construction is consistent with applicable state law that would be applied by the state's highest court. Treas. Reg. § 26.2601-1(b)(4)(i)(C).

The regulations provide an example involving a trust instrument with an ambiguity as to whether trust principal is to be distributed per stirpes or per capita upon termination. The trustee files a construction suit with the appropriate local court to resolve the ambiguity, and the court issues an order construing the instrument to provide for per capita distribution. The regulation concludes that, because the court's construction resolves a bona fide issue regarding the proper interpretation of the trust instrument and is consistent with applicable state law as it would be interpreted by the state's highest court, the trust will not lose its Grandfathered status. Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 3.

4. <u>Other Modifications.</u>

Certain other modifications (including trustee distributions, settlements, and judicial constructions that do not meet the safe harbors described above) made by judicial reformation or non-judicial reformation valid under state law are also permitted under the regulations, provided (i) the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (for GST Tax purposes) than the person who held the beneficial interest prior to the modification and (ii) the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Treas. Reg. § 26.2601-1(b)(4)(i)(D).

In the regulations' example described under item 1 above ("Trustee Distributions"), the safe harbor for discretionary distributions did not apply. However, the catch-all safe harbor did apply. The regulation explains:

> [T]he modification does not shift any beneficial interest in Trust to a beneficiary or beneficiaries who occupy a lower generation than the person or persons who held the beneficial interest prior to the modification. In addition, the modification does not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. The new trust will terminate at the same date provided under Trust. Therefore, neither Trust nor the new trust will be subject to the [GST Tax].

Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 2.

The regulations also provide the following example of the application of this safe harbor to the change in situs of a Grandfathered Trust.

> In 1980, Grantor, who was domiciled in State X, executed an irrevocable trust for the benefit of Grantor's issue, naming a State X bank as trustee. Under the terms of the trust, the trust is to terminate, in all events, no later than 21 years after the death of the last to die of certain designated individuals living at the time the trust was executed. The provisions of the trust do not specify that any particular state law is to govern the administration and construction of the trust. In State X, the common law rule against perpetuities applies to trusts. In 2002, a State Y bank is named as sole trustee. The effect of changing trustees is that the situs of the trust changes to State Y, and the laws of State Y govern the administration and construction of the trust. State Y law contains no rule against perpetuities.

Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 4. The regulation concludes that because the trust will terminate at the same time before and after the change in situs, the change in situs does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation than the persons who held the beneficial interest prior to the transfer and does not extend the time for vesting beyond that provided in the original trust. Therefore, the trust will not lose its Grandfathered status. *Id.*

The regulations provide that if, in the above example, the change in situs resulted in State Y law causing the time for vesting to be extended beyond the period under the original trust, the trust would lose its Grandfathered status as a result of the change in situs. *Id.*

The Treasury regulations also provide an example involving the merger of two Grandfathered Trusts where the merger does not shift any beneficial interests to a beneficiary occupying a lower generation and does not extend the time for vesting beyond the original trust period. Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 6.

For purposes of the safe harbor described in this section, the regulations explain that a "modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust." *Id.* § 26.2601-1(b)(4)(i)(D)(2). The following example is illustrative:

> In 1980, Grantor executed an irrevocable trust for the benefit of Grantor's issue, naming a bank and five other individuals as trustees. In 2002, the appropriate local court approves a modification of the trust that decreases the number of trustees which results in lower administrative costs.

Id. § 26.2601-1(b)(4)(i)(E), Ex. 10. The regulation concludes that the modification pertains to the administration of the trust and does not shift a beneficial interest to any beneficiary occupying a lower generation and the modification does not extend the time for vesting beyond the period provided in the original trust. Therefore, the trust retains its Grandfathered status. *Id.*

B. <u>Gift Tax Issues.</u>

In the gift tax context, a beneficiary who agrees to a trust modification that shifts part of his beneficial interest to another person may be deemed to have made a taxable gift. For example, in the decanting context, the beneficiary who would have received the distribution outright might be treated as making a gift to the new trust by consenting to a distribution in trust for the benefit of contingent beneficiaries.

Treasury regulations provide that transfers that are free from any donative intent and that are bona fide and at arm's length are not subject to gift tax. Treas. Reg. § 25.2512-8. This exclusion may prevent certain trust modifications from resulting in a deemed gift by the beneficiary under some circumstances.

In some cases, trust modifications that would seem to be transfers resulting in a taxable gift may not be treated as such. The reformation of a trust to conform to the settlor's original intent, even though it appears to change the legal rights of the beneficiaries, has been held as not resulting in a taxable gift. For example, in Private Letter Ruling 200318064, Grantor created a trust naming his one child, C1, and any after born children as beneficiaries. The terms of the trust, however, provided that the initial trust assets were to be held for C1 and did not mention after born children. Grantor later had two additional children. Grantor sought a judicial reformation of the trust to conform to his original intent for all of his children to share equally in the assets of the trust. The IRS ruled that the reformation would not result in a transfer subject to gift tax. P.L.R. 200318064 (May 2, 2003).

C. Income Tax Issues.

In addition to gift and GST Tax issues, the modification of trusts often results in income tax consequences to the trust beneficiaries. Following are some of the income tax concerns when considering a reformation of an irrevocable trust.

1. Cottage Savings.

Section 1.1001-1(a) of the Treasury Regulations provides that generally, any gain from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income. Treas. Reg. § 1.1001-1(a). In certain situations, the IRS might argue that a trust modification may be treated as a distribution followed by an exchange of interests among the beneficiaries, resulting in a recognized gain for income tax purposes.

In *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), the taxpayer had exchanged a group of mortgage loans for a different group of mortgage loans. In determining that the mortgage loans were materially different resulting in realized losses to the taxpayer upon the exchange, the Court defined what constitutes a "material difference" for purposes of Section 1001 of the Code. The court stated that properties are materially different as long as their respective possessors enjoy legal entitlements that are different in kind or extent.

In Private Letter Ruling 200231011 (May 6, 2002), the IRS applied the *Cottage Savings* analysis to the modification of a trust. Under the terms of a testamentary trust, the testator's grandson was to receive a fixed dollar amount each year during his life, with the remainder interest passing to various charities. The trust was later restructured to provide for annual income distributions in accordance with a performance chart. Subsequently, disputes arose regarding the administration of the trust and the parties entered into a settlement agreement to resolve the dispute. Under the terms of the settlement agreement, the charities would receive an immediate distribution of corpus in termination of their interest. The remaining amount would continue in trust for the grandson. During his lifetime, the grandson would receive a 7% unitrust amount annually and could receive supplemental income or principal for his reasonable support. On his death, the remaining corpus would be distributed in accordance to the grandson's general testamentary power of appointment. The IRS explained that an exchange of property results in the realization of gain or loss under Section 1001 if the properties exchanged are materially different. The IRS then looked to the definition of material difference under *Cottage Savings* and its application to trusts in two different cases. The first case, *Evans v. Commissioner*, 30 T.C. 798 (1958), involved the exchange of an income interest in a trust for an annuity in which the court concluded was a realization event. The second case the IRS examined was *Silverstein v. United States*, 419 F.2d 999 (7th Cir. 1969), in which the court found that the exchange of an interest in a trust for a right to specified annual payments from the remainder beneficiary did not result in a realization event because the taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust.

The IRS determined that the proposed settlement at issue more closely resembled the situation in *Evans* than in *Silverstein* because grandson was currently entitled to trust income subject to a floor and ceiling, but under the proposed settlement he would receive annual unitrust payments and could receive additional discretionary distributions. The IRS stated, "[e]ven assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required" under the current terms of the trust. He also would not be limited by the maximum annual payment ceiling and payments would be determined without regard to trust income. Therefore, the grandson's interest in the modified trust would entail legal entitlements different from those under the current trust agreement.

The potential treatment of a trust modification as an exchange of property by the beneficiaries requires careful consideration in order to avoid unintended income tax consequences.

2. Dispositions of Term Interests.

The potential income tax problems facing beneficiaries in the trust modification context are magnified by the impact of the basis rule under Section 1001(e) of the Code.

Section 1001(e) of the Code provides a special rule for determining gain or loss from the disposition of a term interest in property. Under Section 1001(e), in determining gain or loss from the disposition of a term interest, generally, that portion of the adjusted basis of the interests which is determined under Section 1014 (regarding basis of property acquired from a decedent), 1015 (regarding basis of property acquired by gift) or 1041 of the Code (regarding transfers of property between spouses) is disregarded. I.R.C. § 1001(e)(1). A "term interest in property" for purposes of Section 1001(e) means a life interest, an interest for a term of years, or an income interest in a trust. *Id.* § 1001(e)(2). An exception to the rule applies where the sale or disposition is part of a transaction in which the entire interest in property is transferred. *Id.* § 1001(e)(3).

In Private Letter Ruling 200231011 (discussed in detail above), after concluding that the grandson's interest as modified would entail different legal entitlements from those he possessed under the original agreement thus resulting in gain recognition, the IRS went on to explain that, under Section 1001(e)(1), the portion of the adjusted uniform basis assigned to the grandson's interest in the trust is disregarded because it was a term interest. Accordingly, the grandson was required to recognize gain on the entire amount received.

IV. CONCLUSION.

Techniques such as judicial reformation, merger, change of situs, decanting, and sales to new trusts can make irrevocable trusts much more flexible than one might assume. The specific problem to be addressed may make one method more attractive than the others depending on the surrounding circumstances. In choosing among the available methods for modifying irrevocable trusts, practitioners must also be aware of the federal tax consequences that can result from the various forms of modification.

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