

Renegotiating The Irrevocable Trust: Amending, Decanting, And Judicially Modifying

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A. Introduction

1. Irrevocable trusts serve a wide variety of tax and nontax objectives. Circumstances and laws change over time, as do the objectives and desires of settlors, trustees, and beneficiaries. Those advising trustees and beneficiaries are likely to encounter clients whose interests may be served by a change in one or more terms of an irrevocable trust. Fortunately, irrevocable does not mean immutable. Irrevocable trusts can often be modified or even terminated, if circumstances warrant, although the options available to modify terms of an irrevocable trust may be limited by the terms of the trust, state statutes, applicable tax laws, and a trustee's fiduciary duties.
2. This outline surveys the broad array of tools available to advisors in reviewing with their clients the ability to amend trust terms that fail to meet the objectives of a trustee or beneficiary. It discusses drafting suggestions that may allow for flexibility in trust administration and increasing the scope and variety of options available for modifying terms of irrevocable instruments.

B. Available Drafting Options To Provide Flexibility

1. A trust instrument may be well drafted not only because of what the drafter specifically anticipates and provides for in the trust terms but also because the drafter may recognize that circumstances and events arise that cannot be anticipated. Flexibility drafted into a trust instrument can save time and effort when seeking reformation at a later date. This section addresses types of provisions that permit future changes to a trust.

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- a. *Independent Trustees And Trust Protectors.* Independent trustees may be able to exercise a broader scope of powers than a trustee who is in the settlor's family or is a trust beneficiary. Throughout this article, the terms "settlor," "grantor," and "trustor" are used interchangeably. An individual or entity unrelated to the grantor and who is different from and independent of the trustee may be designated as "protector" or "special trustee" to make certain designated decisions affecting trust terms, even though that individual or entity is not a trustee. Use of trust protectors has been common with foreign trusts, and protectors are now more frequently designated for domestic trusts. Especially where the grantor must give up title and control of property during his or her lifetime or where a testator had special confidence in an individual who is unable to serve as trustee, he or she may want to select such a person to hold powers to change or amend the trust. Some of the types of powers that may be granted to an independent trustee or a trust protector are discussed below.
- i. *Power To Modify Or Terminate Trust.* A person who is preparing a long-term trust should recognize that circumstances for beneficiaries may change and that events may turn out differently from those contemplated by the settler. In addition it is necessary to recognize the possibility of changing tax laws, to acknowledge that there may be acquisition of certain trust assets not originally held in trust, to note the likelihood that the situs of the trustee and trust may change, and to plan for a host of other future uncertainties. Provisions included in advance permitting a trustee or trust protector to amend, modify, or terminate the trust may facilitate efficient administration in the future. Internal Revenue Code ("IRC") §2038 causes property to be included in a decedent's gross estate if property is transferred by gift and at the date of death enjoyment of property was subject to change through exercise of a power by the decedent or in conjunction with others to amend, revoke, or terminate. Giving the power to another person alone, however, may avoid this result. See *Ballard Est. v. Comm'rs*, 47 B.T.A. 784 (1942), *aff'd per curiam*, 138 F.2d 512 (2d Cir. 1943) (wife had power to amend and revoke inter vivos trust). Caution: this may not be applicable in all circumstances in a community property state. Other such advance provisions may include: creation of separate shares for special assets (real estate or S corporation stock), change of governing law if the trustee moves, termination of small trusts, and additional provisions discussed below. Because not all future events can be anticipated, granting the power to modify or terminate to a trust protector or independent party may add flexibility to the trust and avoid the need for judicial proceedings to seek modifications.
- ii. *Add Or Modify Powers Of Appointment.* Attempting to weigh all anticipated tax consequences in advance leads to interesting discussions and sometimes to missed opportunities. Trust terms expressly giving a protector the power to add or modify a power of appointment permit a decision to be made after time has passed and the protector knows what tax laws apply. An example of this and a recommendation is reflected in *Price on Contemporary Estate Planning* (2d ed. 2000). John R. Price contemplates authorizing trustees to amend a trust to add such a power:

Trusts can be drafted to allow trustees to take advantage of the unified credits and GSTT exemptions of first generation beneficiaries. In particular, trusts can permit trustees to make outright distributions to the transferor's children or other nonskip persons. As a result of the distributions the children (or other distributees) would own the property and the original transferor would no longer be connected with it for GSTT purposes. The same goal can be achieved if an independent trustee exercised a power to grant a general power of appointment to a child or another nonskip person.

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- iii. *Add Beneficiaries.* In most instances, trust provisions can be drafted broadly enough to include classes of persons or charities, and the trustee will have sufficient discretion to direct trust distributions as appropriate. The power to add beneficiaries may be included for unforeseen circumstances. This type of provision is often included in irrevocable trusts to allow for grantor trust tax treatment. IRC §671.
- iv. *Amend Administrative And Dispositive Provisions.* A trust protector may be given powers to change a trustee's responsibilities, for example, types of assets held in trust, change of trust situs, or amounts of distributions.
- v. *Turn Grantor Trust Provisions On And Off.* Under the grantor trust provisions of IRC §671 to §679, the grantor (or some beneficiaries) may remain subject to income taxes for trust property. While such provisions may be feasible at the initial establishment of a trust, circumstances may change so that the grantor may no longer want or be able to pay such taxes, for example, a change in financial circumstances of the grantor or beneficiary or substantial appreciation in the trust property. A provision permitting another person to modify the trust terms that cause the trust to be a grantor trust may prove beneficial in the long run.
- b. *Trustee Succession, Removal, And Appointment.* Provisions for trustee succession should be included in a trust instrument to cover situations in which the original trustee is no longer able to serve. Other possible circumstances to permit changes in the trustee include giving someone independent of the trustee (beneficiary, trust protector, and in limited circumstances, the grantor) the power to remove a currently serving trustee for any reason, to appoint a cotrustee to serve with a currently serving trustee, and to change successor trustees from those originally designated. *See Byrum v. U.S.*, 440 F.2d 949 (6th Cir. 1971), *aff'd*, 408 U.S. 125 (1972) (grantor power to replace trustee with corporate trustee does not make trust includable in grantor's estate); Rev. Rul. 95-58 (grantor did not retain powers of trustee by reserving right to remove trustee and appoint individual or corporate successor trustee not related or subordinate to decedent).
- c. *Powers Of Appointment.* Powers of appointment granted in a trust instrument permit a beneficiary to redirect disposition of property and to change terms set forth by the original grantor. Such power of appointment may be a general power or a limited power.
- i. A general power of appointment as defined in IRC §2041(b)(1) is a power "exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate" with some specific exceptions. Such power of appointment results in inclusion of the property subject to the power in the taxable estate of the power holder. IRC §2041(a).
- ii. A limited power of appointment, while not causing the subject property to be taxed in the power holder's estate, does not permit extensive restructuring of the grantor's plan. In many cases, however, the power can be defined so that it is broad enough to permit exercise for the benefit of the likely trust beneficiaries, for example, family members or charities.
- d. *Power To Delay Distribution.* The grantor may give the trustee power to delay distributions beyond ages or events stated in the trust instrument. Intervening circumstances or events may change the wisdom or need for distributions as originally contemplated by the grantor. There may be positive

events, such as more significant trust appreciation than originally anticipated or increased individual wealth for the beneficiary. In such an instance, the interest or desire of the beneficiary may dictate the need for modification. There also may be negative events, such as a beneficiary going through a divorce, going through bankruptcy, or one with drug, alcohol, or other substance abuse problems. The grantor also may have preferences but not be able to predict or control beneficiary actions, for example, graduation from college or seeking gainful employment. To anticipate or provide for these instances, trust provisions may be drafted to give a trustee the power to adjust or delay distributions beyond a specifically stated age for the beneficiary.

- e. *Powers To Change Trust Situs And Governing Law.* Provisions permitting the change of trust situs, with a corresponding change in the governing law, or a provision permitting the trustee to change the governing law may permit changes that will affect other terms of the trust. Differences exist from state to state in key provisions and tax impact, including the following: perpetuities, enforceability of no-contest provisions, state income taxation, state estate taxation, ability and procedures to amend a trust, and principal and income provisions.
- f. *Sale Of Life Insurance Policy Between Grantor Trusts.* The sale of assets between two trusts treated as wholly owned by one person, such as a sale between the individual and a grantor trust, is ignored for income tax purposes and may allow for the transfer of trust assets from an existing trust to new trust with more favorable or preferable terms. Until recently cautious planners have had reservations about recommending the sale of a life insurance policy by one grantor trust to another, fearing that the Internal Revenue Service (“IRS”) might attempt to apply the “transfer for value” income tax rules under IRC §101(a)(2) to limit the general exclusion of the death benefit from income. Recently, however, the IRS settled this issue by affirming its determinations in several earlier Private Letter Rulings that the transfer of a life insurance policy for valuable consideration is not a transfer for value under IRC §101(a)(2). *See, e.g.,* Priv. Ltr. Ruls. 2005-18-061, 2005-14-001, 2002-28-019, 2002-47-006; Rev. Rul. 2007-13, 2007-1 C.B. 684.
 - i. Where the terms of an irrevocable life insurance trust (“ILIT”) have become undesirable to the settlor, he or she may establish a new ILIT with preferable terms and advise the trustee that gifts to the initial trust will be discontinued and future annual or other gifts will be made solely to the new ILIT. In these circumstances, it would appear justifiable for the trustee of the initial ILIT to sell the existing policy to the new ILIT, especially if beneficiaries of both trusts are the same or if the trust holds only term insurance that would otherwise lapse for lack of funds to pay future premiums. If the policy has significant value or the beneficiaries of the two trusts differ, the trustee of the initial trust should carefully consider whether a sale of the policy is consistent with the trustee’s fiduciary duties. In most cases, it would appear that the receipt of fair market value for the insurance policy should satisfy a trustee’s fiduciary duties to the beneficiaries of the initial trust. If the consideration received by the initial trust is relatively insubstantial, the trustee of the initial trust may consider distributing the trust property to its current beneficiaries or terminating it under small trust termination rules after taking into consideration the potential for adverse tax and other consequences.