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MARTIN SHENKMAN AND SANDY GLAZIER EXPLORE THE OPPORTUNITIES NOW AVAILABLE VIA VARIOUS STRATEGIES TO MODIFY AND PERHAPS SIGNIFICANTLY REVISE TRUSTS THAT ARE STILL TECHNICALLY "IRREVOCABLE."

Review Irrevocable Trusts for Potential Enhancements through Modification

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Introduction

Historically, an irrevocable trust was just that, irrevocable. We would explain the concept of an irrevocable trust to clients using terms like "can't be changed," "carved in stone," and so forth. Well, that may no longer the case. There are now various ways to modify or perhaps significantly revise what is still called an "irrevocable" trust.

Modern approaches to estate planning reflect consideration of these options during the drafting stage. The grant of absolute, unlimited or unrestricted discretionary trustee powers of invasion, permissible merger or division of trusts, the ability to trigger or grant limited or general powers of appointment, and broad trust protector discretionary powers (including the power to amend certain provisions, extend the time for distributions, grant powers of appointment or permit decanting of assets to another trust) can all impact the extent to which an irrevocable trust might be subsequently merged, decanted or otherwise modified.

The review and analysis of an already funded "irrevocable" trust might identify tax and other benefits which could improve the administrative provisions of the "irrevocable" trust or otherwise assist effectuation of the settlor's (or a beneficiary's) desires[2]. Enhancing our knowledge of these considerations and the options available to effectuate change can provide an array of estate planning opportunities.

This article presents an overview of why we might want to suggest that clients explore modifying an old irrevocable trust and some of the methods that might be utilized.

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Common Old Irrevocable Trusts Clients Might Benefit from Modifying

While the types of old irrevocable trusts that might benefit the client by modification, and the reasons for such modifications, are as varied as client circumstances, the four situations outlined below are common and may drive home the key point that this type of review and planning can be valuable for many clients.

√ L**ife Insurance Trust.** Many old irrevocable trusts have significant assets but were not designed to hold life insurance. A client may have a current insurance need, and/or an existing irrevocable life insurance trust ("ILIT") to which the client makes annual gifts and for which the trustee issues annual Crummey power notices, to pay premiums on existing policies. Either of these common situations might be improved by modifying the existing irrevocable trust (i.e., the non-insurance trust) so that it can hold life insurance, and if the client has an existing ILIT, decanting or merging it into the modified irrevocable trust.

This approach can permit redeployment of significant dollars in the old irrevocable trust to cover insurance premiums, simplify the client's planning by eliminating extraneous trusts, and improve their overall planning by modernizing the remaining trust in the process. In some instances the impediment to achieving these benefits is that the old irrevocable trust does not have a person who can serve as trustee for the life insurance. This might occur for a host of reasons. The trust might have named the spouse as a trustee or co-trustee without a separate insurance trustee provision and the spouse cannot have powers of life insurance on her life without creating estate inclusion issues. In other situations, the trust might have named an institutional trustee who will not approve the insurance the clients wish to have the trust purchase, or for which the economics of involving the institution are

not viable. Whatever the case, there are no doubt many old irrevocable trusts that can be made more flexible by becoming insurance trusts in addition to whatever other type of trust they might have previously been.

The opposite approach might also be used. If a client has an existing ILIT and is frustrated making annual gifts and issuing Crummey power notices (all clients seem to despise this administrative hassle) they might enhance the existing ILIT and make gifts to a more robust trust of real estate investments or family business interests. Thereafter, the cash flow from the real estate or family business can be used to pay life insurance premiums and eliminate the need for annual gifts and Crummey powers.

Many old ILITs were drafted at a time when conventional planning might have had assets held in the trust until each child is age 35 and then make a distribution outright of that child's share upon attaining that specified age. Practitioners are well aware that a longer term or perpetual trust is preferable to maintain asset protection, divorce protection and avoid inclusion in the child or other beneficiary's estate. Decanting may provide an ideal tool to correct this old-style trust by merging it into a more modern and protective trust.

√ **Credit Shelter (Bypass) Trust.** The need to modify an old credit shelter trust (also called bypass trust or applicable exclusion trust) can be illustrated with a simple example. Mr. and Mrs. Jones were married and had a $2.5 million estate. When the estate tax exemption was $1 million they realized they faced a significant estate tax cost and hired an estate planning attorney to help them address that tax fear. The result was a plan that included a bypass trust and the division of assets approximately equally between husband and wife. When Mr. Jones died $1 million was transferred into a bypass (credit shelter) trust to benefit Mrs. Jones. The benefit at that time was that she could receive distributions from the bypass trust but the assets of that trust would not be included in her taxable estate when she died. At the time of creation, the plan would have dramatically reduced their estate tax on her later death. However, the estate tax exemption in 2019 is $11.4 million and portability now permits Mrs. Jones to preserve her husband's exemption amount should she desire to do so without the complexity and cost of a credit shelter trust. Many of these old bypass trusts still exist and are managed based on the old audit acronym "SALY," "same as last year". Too often no one questions what is the point of the trust? Well clearly one point is that the assets in the trust will remain protected if Mrs. Jones is sued, or if her capacity wanes. Those assets might be more difficult for a perpetrator to reach in an elder abuse scam, and if Mrs. Jones remarries those assets could be protected for the Jones children. While these benefits might be significant, they may not be primary concerns for all clients and the detriments merit consideration. One detriment may be that when created the portability option for estate tax avoidance was not available. Another detriment may be the result in a shift in tax rates which has, for many, made the income tax consequences more impactful than the federal estate tax. In addition, the cost of tax preparation fees annually, and perhaps occasional legal fees when an issue arises, are not appreciated by Mrs. Jones or the children. Finally, if the assets in that trust have appreciated they will not benefit from a basis step-up on Mrs. Jones' death because they are not included in her estate. In many, but not all, such situations Mrs. Jones and the family might all appreciate eliminating this trust. Another option might be to decant into a newer trust with Mrs. Jones being granted a narrow general power of appointment over appreciated trust assets, e.g. to appoint to her creditors or descendants from the prior marriage. That might retain some of the protection of the trust but permit estate inclusion to garner a basis step up.

There might be another aspect to revisiting the purpose and purported benefits of the bypass trust. Mr. and Mrs. Jones lived in a high tax state. After Mr. Jones died and the bypass trust was created in that high tax state, Mrs. Jones might have moved to a warmer (and tax-friendlier) climate. It might be that by eliminating the old bypass trust (if feasible) or decanting to a new trust (and perhaps changing trustees or other characteristics that taint the trust as still taxable in the high tax state), the trust might avoid paying state income tax in the high tax state on some of the earnings of the bypass trust.

√ **Child/Grandchild Trust Ending at Specified Age**. The traditional way many trusts for children and grandchildren were structured was to provide payouts over time. For example, the child would receive a distribution of 1/3rd of the trust principal at age 25, ½ of the remaining principal (equivalent to the 2nd one-third share) at age 30, and the final remainder (equivalent to the 3rd one-third share) at age 35. The "logic" of this was that at 25 the child should be done with college and perhaps graduate school so distributing some funds might be

appropriate. Perhaps by age 30 the child was married and buying a house so a distribution might be reasonable. And finally, by age 35 the child should be mature enough to manage his or her own assets. Well, so goes the theory. There are however practical problems with this theory. At what age might the child be sued or divorced? Perhaps the child has a substance abuse problem, or becomes incarcerated. Why put any assets directly in the child's name and subject them to risk? Wouldn't it be better that the assets stay in the trust until needed to provide a safety net for the beneficiary and protect the assets? An even better result might be to retain the assets in the trust forever and let the child benefit from them. So, if the child wants to buy a house the trust could purchase part or all of the house. The child could live in the house just as if he or she owned it directly, but the house would be protected from lawsuits or divorce. If the child wanted to start a business the trust could loan money to that business and take a security interest (lien) on assets of the business to protect the value involved inside the trust. It may be prudent to review all irrevocable trusts for these issues. In many (if not most) cases old trusts have mandatory payout ages or mechanisms. From a trust administration perspective, in many cases, those ages may have long ago past but no one addressed the required trust distribution. From a planning perspective, depending upon the terms of the trust and possible change of venue options, some of these provisions may be revisited and perhaps extended or otherwise modified. The case of Ferri v. Powell-Ferri,[3] illustrates the potential import and value of this type of planning. While the case is extreme and may not be followed in other state courts, it highlights what might be feasible and why review and analysis of irrevocable trusts may be of benefit to clients.

In the Ferri[4] case, the trustee wanted to try to protect the beneficiary's interest in trust assets as a result of and during the pendency of divorce proceedings. It's generally preferable to plan and take corrective actions well in advance of a beneficiary's divorce or other event which could result in a possible attack on the beneficiary's interest in a trust. Clients need to be educated that traditional or historic trust drafting commonly relied on techniques and provisions that are less than optimal, such as mandatory income distributions, mandatory principal distributions as specified ages, or as in the Ferri case permissible withdrawal rights of trust principal. Many clients assume erroneously that an irrevocable trust is inviolate and that with tax laws in flux no planning is necessary. Modifying old (perhaps now inefficient) irrevocable trusts can be about more than tax planning considerations as the Ferri case illustrates. The Ferri case also suggests an important point that should not be overlooked. Decanting is a process, unless the governing instrument provides to the contrary, to be carried through by the trustees, not by the beneficiary. Practitioners and clients alike should be cautious to monitor communications and the process to assure that the beneficiary seeking protection is not directing the decanting process or the favorable result achieved in Ferri may not be replicated. It should also be noted that the Massachusetts Court did not have a state decanting statute to influence the outcome of the decision. If there is applicable state law (and more than 20 states now have decanting statutes[5], while still others have common law approaches which can facilitate decanting), the contents of such statutes and common law approaches can be critical to the outcome.

A simplified timeline of the Ferri case is as follows:

1983 - Creation of a trust for child/beneficiary;

1995 - Child/beneficiary's marriage;

2010 - Child/beneficiary's divorce is commenced;

2011 – Decanting of trust into a new trust to protect trust assets.

In Ferri, the settlor - parent created a trust for the sole benefit of the child/beneficiary. The trustee had the discretion whether to pay trust assets to the child/beneficiary or, to instead, set them aside for the child/beneficiary. In addition, the child/beneficiary could demand increasing percentages of trust corpus at specified ages beginning with 25% of trust assets at age 35 and increasing in increments to 100% of trust assets after age 47. The child/beneficiary had the right to demand 75% of the trust assets of the old trust based on the trust terms when his wife filed for divorce. As a consequence, the trustees became concerned that the child/beneficiary's (soon to be) ex-spouse might reach trust assets which the child/beneficiary was entitled to withdraw. Perhaps, it should be noted that even though the trust assets may have constituted separate property not subject to equitable distribution in the divorce, the court opinion(s) noted the historic reliance by the divorcing parties, as a family unit, on distributions from the trust. In addition, in some states, the mere fact that an asset is

considered separate in nature, might not protect the invasion of that asset under the proper set of circumstances (such as need or claimed contribution). To reduce the risk of invasion or compelled distribution, the trustees merged the old trust (decanted it) into a new trust and poured the assets of the old trust into the newly created trust. More specifically, the trustees of the old trust created a new trust naming themselves as trustees. Then they distributed assets from the old trust to the new trust in a decanting. The decanting was done without the consent of the child/beneficiary. During the period between commencement of the divorce and completion of the decanting process, the child/beneficiary's right to withdraw the trust assets increased under the terms of the old trust to 100% (i.e. he could take all the assets). The new trust, as would be anticipated, eliminated the child/beneficiary's right to demand trust corpus at specified ages. The new trust was formed in Massachusetts.

In the Ferri case, the Connecticut Court requested that the Massachusetts Court determine whether the trustees of the old trust validly distributed the trust assets from the old trust to the new trust. While the Court determined that there was no specific decanting power under Massachusetts law, the trustee's power to decant depended on the governing instrument and the facts. The rationale justifying decanting in the instant case was that since the trustees had the discretion to distribute trust property to or for the benefit of the beneficiary, the power of the trustee to distribute the property to another trust for the benefit of the same beneficiary should be subsumed under the broader distribution power. The Court noted broad discretion afforded the trustees in the old trust, the anti-alienation provision, the beneficiary withdrawal rights, and the settlor's affidavit regarding his intent in creating the trust. The Massachusetts court concluded that the terms of the old trust and the facts involved corroborated the parent/trustor's intent to permit decanting.

The same result might not have been realized if the child/beneficiary had requested the trustees decant, or if the beneficiary were involved in the process. This could make the child/beneficiary's involvement (or lack thereof) critical to the success (or failure) of decanting in similar situations.

The lesson of the Ferri case is that it may be possible, even in bad fact situations, to improve the results a beneficiary might face by changing the terms of an old irrevocable trust. Obviously, the longer the modifications are completed before an event occurs (e.g., lawsuit, divorce, etc.) the better. This is precisely why practitioners might consider being proactive in identifying trusts that might be improved.

√ **High Tax State Trust**. If a trust is subject to income tax in a high tax state, is that necessary or optimal for the trust and its beneficiaries? While the analysis and options for optimizing state income tax consequences will vary significantly based on state law, the following general discussion may highlight this issue for practitioners. If a trust is based in and taxed in a high tax state, but all beneficiaries live in the high tax state and all trust income is distributed annually, there may be no benefit to moving the trust. But in other situations, there may be significant benefits. For example, perhaps income is retained in the trust because the beneficiaries do not require current distributions. It may be beneficial to review the totality of the tax status of the trust and beneficiaries and determine if changes might improve the state income taxation of the trust and beneficiaries, overall. In some instances, changing the trustees might suffice to end taxation in a high tax state and improve the overall tax position of all. In other cases, more action might be required, and that more might entail modifications to the trust or its administration (e.g., a formal change of governing law and situs of trust administration, division of the trust into two (or more) separate trusts so a business with nexus to a state is in one trust and passive investment assets with no connection to the high tax state are in another trust, etc.). Consider in this analysis the recent Kaestner case.[6] Kaestner might be read to suggest that decanting the trust into a new trust that only permits discretionary distributions as determined by an independent trustee, and which is a long term trust that does not provide for distributions at any specified age, might enhance the likelihood of avoiding taxation in a high tax state.

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How Clients Can Modify an Irrevocable Trust

How can the transformation to accomplish better tax, asset protection or divorce protection be accomplished? There may be several possibilities, depending upon the terms of the trust and possible situs and jurisdiction(s) involved.

√ **Trustee Resignation and New Appointment**. If all that is desired is to cut off the nexus to a high tax state it might be possible to effectuate tax savings if a current trustee who resides in that high tax state resigns and a new trustee in a low tax state is appointed. If there aren't individuals qualified to act in the low tax state that the interested parties (having the power to nominate or appoint successors) are comfortable with, it might be possible to name an institution in that state. The state income tax savings may more than offset the annual trustee fees. In some instances, the change in fiduciaries might be a simple matter accomplished under the obvious terms of the trust. Perhaps the trust even permits the old trustee to resign and as part of that resignation designate a new trustee.

√ **Pursuant to the Terms of the Trust**. While some modern trusts are so flexible that they, by their terms, might permit a host of modifications (e.g., trust protector action), few older trusts are as malleable. So, depending on the changes desired, a careful reading of the trust might provide all that is necessary. For example, the client has an old life insurance trust and wants to forgo the trustee's annual issuance of Crummey powers. It may be possible that the annual demand or Crummey power provision might permit a one-time written waiver of future notices. If the client's estate is so far below the estate tax exemption that tax concerns are no longer relevant, perhaps that might be advantageous to simplify the cost and hassle of administering the trust. It might be advisable to review the trust with the client's CPA, in order to gain a fuller understanding of potential tax ramifications. In some cases, what was initially ignored as mere "boilerplate" in the trust document might suffice to permit important changes.

√ **Trust Protector Action**. More modern trusts commonly include a position that may be called "trust protector" although other titles are common. Review the terms of the trust to determine what that person's authority is. Many trusts will list the specific powers or rights the person acting as protector can take. About 20 states now have trust protector statutes (and are more likely to follow).[7] So, for example, if the goal was to divide the trust into two parts, one holding business interests of a business that is actively conducted in the client's home state, and a second trust owning marketable securities that could be moved to a low tax state, the combination of trust powers and trust protector action might simply suffice with no need for more. For example, the general trust provisions may give the trustee the power to divide the trust into multiple parts. The trust protector may have the power to change trustees and move the situs and governing law of the trust to a new state. The trustee could then divide the trust into business and marketable security trusts. The trust protector could then move the trust holding marketable securities to a new state and the family might thereafter realize significant annual state income tax savings.

√ **Decanting**. Decanting is a process of the trustee creating a new trust and pouring over the old trust assets into that new trust. This might be achieved in one of three ways. Many modern trusts might include a provision giving the trustee the right to decant expressly in the trust document itself. In such cases, the trustee can decant the trust by following the powers given. Some states without a statute might permit decanting by case law. The ability to merge trusts for ease of administration, may provide broad enough language to permit decanting. Moreover, a form of decanting might be effectuated via the use of powers of appointment (when provided for in the instrument and applicable). Finally, if the trust is silent (as most old trusts are) and the state where the trust is based does not permit decanting, it might be possible to move the trust to a new state that does permit decanting (e.g., New York and Alaska have robust decanting statutes) and then decant after the move.

√ **Non-Judicial Modification.** Another approach to changing an old irrevocable trust would be to engage in what is referred to as a "non-judicial modification." This is, as the name implies, a modification of an old irrevocable without court involvement. Michigan permits modification of non-charitable trusts: (i) upon the consent of the qualified trust beneficiaries and a person or committee that is is given the power under the terms of the rust to grant, veto, or withhold approval of termination or modification of the trust, or (ii) by a trustee or other person or committee that is given the power to direct the termination or modification of the trust.[8]

Delaware, for example, has a very more robust, although relatively new, statutes governing non-judicial modification.[9] The Delaware non-judicial modification statute provides that:

[n]otwithstanding any provision of law or a trust's governing instrument limiting or prohibiting amendment of the trust, an irrevocable trust may be modified to include any provision that could have been included in the governing instrument of a trust created upon the date of the modification upon written consent or written nonobjection of

the trustor, all then serving fiduciaries and all beneficiaries even if the modification violates a material purpose of the trust.[10]

A number of requirements must be met for a trust to avail itself of this approach. Delaware law must govern the administration of the trust. This requirement can be met if the trust has a Delaware corporate trustee.[11] The settlor must be living and competent. Several different persons must consent, or not object, to the modification including: (i) the settlor, (ii) all fiduciaries (this may include a separate general, administrative, investment and distributions trustee), and (iii) the current beneficiaries must also consent.

The gist is that non-judicial modification might permit revision of the terms of the old irrevocable trust to add any new provisions or modify any old existing provisions that are desired. For example, if an old irrevocable trust did not have an insurance trustee or insurance provisions, it may be possible, through non-judicial modification, to add such a provision and thereby convert an old irrevocable trust into a robust insurance trust holding other assets. As discussed above this could enable that old trust to now own life insurance and because it has other assets it might avoid the need for annual gifts and crummy powers to pay insurance premiums. This process might also permit a bifurcation of the trustee role, or perhaps more specifically the investment trustee or advisor role, into a general investment adviser position and a separate insurance adviser or trustee provision naming someone independent to serve in the latter capacity. Such a bifurcation may permit the client to continue to serve as the investment trustee of her trust determining which family business interests to retain, while a new independent person, who would not be insured by the trust, would hold all insurance related powers. If the trustee must effectuate the decanting in order to achieve these goals (especially an institutional trustee), the availability of a non-judicial modification to which all parties consent (not just the institutional trustee), may prove a more alluring path.

Caution should be exercised in using a non-judicial modification as discussed above in the context of the Powell-Ferri case. If a beneficiary's consent might have an adverse impact (e.g. in a divorce or creditor challenge), perhaps a decanting done solely by an independent trustee might be preferable.

√ **Judicial Modification**. In some instances, judicial modification or reformation might be an available option. At times it will be the preferred path either because of an abundance of caution, other concerns, or because other options do not suffice. Courts may modify, terminate or, in some instances, reform a trust under a myriad of circumstances that go beyond those available under the other options outlined in this article. A court may modify or terminate a trust or remove a trustee and appoint a different one if it determines that the value of the trust is insufficient to justify the cost of administration.[12] It might even reform an unambiguous trust to conform to the terms of a settlor's intentions, if those intentions are proven by clear and convincing evidence, under the right set of circumstances.[13]

Conclusion

Clients should be encouraged to have their existing irrevocable trusts reviewed and analyzed for possible planning opportunities. Whether for divorce, tax planning (whatever the future law changes provide), general asset protection planning or other reasons, modifying those old trusts through fiduciary actions, decanting, non-judicial modification, or judicial modification might result in significant improvements or other benefits.

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[2] In Richard W. Nenno's, Delaware Trusts 2017, ©2017 Wilmington Trust §11 at p. 22, he recognizes that "recent statutory initiatives, including the Uniform Trust Code, have eroded the *Calfin* doctrine and moved towards prioritizing the wishes of beneficiaries" but in Delaware the settlor's intent controls. See also, In re Tr. Under Will of Flint for the Benefit of Shadek, 118 A.3d 182, 194 (Del. Ch. 2015).

[3]Ferri v. Powell-Ferri, 476 Mass. 651 (2017).

[4]Id.

[5] See M. Patricia Culler, Hahn Loeser & Parks LLP, Cleveland, OH, State Decanting Statutes Passed or Proposed as of August 20, 2018, ,

https://www.actec.org › assets › Culler-Decanting-Statutes-Passed-or-Proposed.pdf.

Since that summary was published Illinois has enacted a decanting statuteand as of November 22, 2019, Massachusetts was considering adoption of some form of the Uniform Trust Decanting Act. https://www.uniformlaws.org/committees/community-home?CommunityKey=5b248bac-9251-47fb-bad8-57a23f3df540.

[6] On June 21, 2019, the Supreme Court of the United States published its decision in North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust, 139 S. Ct. 2213, 204 L.Ed. 2d 621, 2019 U.S. Lexis 4198 (2019) (Kaestner).

[7] See Andrew Huber, Trust Protectors: The Role Continues to Evolve, ABA –RPTE Probate & Property Magazine: Volume 31 No.01 https://www.americanbar.org/publications/probate_property_magazine_2012/2017/january_february_2017/2017_aba_rpte_pp_v31_1_article_huber_trust_protectors.html

[8] See MCL 700.7411(1)(b) and (c). However, this non-judicial process does not apply to irrevocable trusts created before or to revocable trusts that became irrevocable before April 1, 2010. MCL 700.7411(2).

[9] 12 Del. C. §3338 (2015) and 12 Del. C. §3342 (2016).

[10] 12 Del. C. §3342(a).

[11] 12 Del. C. Sections 3332(b) and 3340.

[12] See MCL 700.7414.

[13] See MCL 700.7415 and MCL 700.7416.