UNCONTESTED TRUST MODIFICATIONS:
TIPS AND TECHNIQUES

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PRACTICE CONCENTRATION

<u>Estate Planning.</u> Planning and drafting for the protection and disposition of wealth through the use of various techniques, including lifetime gifts, intra-family sales, life insurance trusts, family limited partnerships, limited liability companies, asset protection trusts, and other complex trusts.

<u>Business Continuation Planning</u>. Business continuation planning for owners of closely held businesses, including formation of closely held businesses, buy-sell agreements, split dollar life insurance agreements, business recapitalizations, and certain non-qualified deferred compensation agreements.

<u>Charitable Gift Planning</u>. Charitable gift planning, including charitable remainder trusts, charitable lead trusts, and creation of exempt organizations in connection with charitable planning.

<u>Estate and Trust Administration</u>. Administration of trusts and estates, including dependent, independent and ancillary probate procedures, guardianships, income tax planning, preparation of U.S. Estate Tax returns, audit negotiations with agents of the Internal Revenue Service, preparation of tax protests, private letter ruling requests and coordinating dissolution of partnerships and closely held corporations.

<u>Fiduciary Representation and Estate and Trust Controversy Matters</u>. Representing fiduciaries and coordinating fiduciary litigation matters, including fiduciary liability issues, will contests, and trust modification and construction issues.

<u>Marital Property Issues</u>. Texas community property system and related marital property matters, including premarital and post-marital partition and/or property agreements between spouses.

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I. INTRODUCTION

A. Scope and Purpose

The purpose of this article is to provide an overview of the main techniques available to lawyers who encounter clients desiring to modify irrevocable trusts when all interested parties are in agreement. As such, a full discussion of each of the techniques mentioned is beyond the scope of this article. Instead, the author has attempted to provide enough detail for the practitioner to make an informed decision about which techniques might be worth exploring in more detail for any given client as well as enough of a warning about treading too deeply into unfamiliar waters. Accordingly, the practitioner would be well advised to conduct further research before seeking to implement any of the techniques described in this article.

B. Reasons to Seek Trust Modification

Several common reasons for seeking a modification of an irrevocable trust are as follows:

- Remove corporate trustee requirement
- Allow appointment or removal of trustees without court involvement
- Correct poor drafting or a drafting mistake
- Change in federal or state tax law
- Change in state law (e.g., rule against perpetuities)
- Divide a pot trust into separate trusts
- Combine two or more trusts
- Change of situs or of governing law
- Give a beneficiary a power of appointment
- Extend the termination date of a trust for tax or asset protection purposes
- Convert a grantor trust to a non-grantor trust, or vice versa
- Add special needs provisions
- Add additional protections for beneficiaries due to changed or unexpected circumstances (e.g., substance abuse, marital issues, and creditor issues)
- Modify trust investment standards
- Fix a poorly administered life insurance trust

II. OVERVIEW OF AVAILABLE TOOLS AND TECHNIQUES

Certainly, it is necessary to involve a court when one interested party seeks modification of an irrevocable trust against the wishes of one or more other interested parties. Even when all interested parties agree to the proposed modification of an irrevocable trust (i.e., an uncontested modification), it is often necessary or helpful to seek judicial action. However, there are many occasions when no court action is necessary in order to modify an irrevocable trust.

This portion of the article provides an overview of the main techniques for modifying (or terminating) an irrevocable trust and when each might be appropriate.

A. Modification By Distribution (a.k.a. Decanting)

1. Common Law Decanting

There is a lot of current discussion about the "new" concept of decanting, though the practice has been around for a long time and has been recognized under the common law at least as early as a 1940 Florida Supreme Court case. *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940).

The idea of decanting is to "pour" assets from an existing trust to a new, more desirable trust pursuant to the distribution provisions of the exiting trust. The legal theory under the common law is that a Trustee with the discretionary power to distribute income or principal outright to the beneficiaries therefore also has the discretionary power to distribute property to a trust or trusts for those beneficiaries.

More specifically, the power to decant under the common law is a special power of appointment exercisable by the trustee in a fiduciary manner. Unlike a typical special power of appointment held by a non-trustee which is exercisable in a non-fiduciary manner, the trustee who considers decanting must be sure to meet all fiduciary duties when exercising such power.

Because the trustee must fulfill all fiduciary duties when decanting, the proposed decanting may not work if the resulting trust provides certain beneficiaries with a greater benefit and others with a lesser benefit under the terms of the new trust. Such an analysis is highly factual in nature, and must even consider whether in certain circumstances the trustee has an affirmative fiduciary *duty* to decant!

For example, if a large Texas trust contains administrative provisions that are unnecessarily costly or contains outdated or highly restricted investment provisions, does the trustee have a duty to decant (or otherwise seek modification of the trust) in order to preserve the trust estate? What about to fix or improve the tax status of the trust in a manner that clearly would benefit all of the beneficiaries?

Texas does not currently have a decanting statute. Scholars and practitioners continue to debate whether common law decanting is available under Texas law and, if so, how certain the trustee can be that decanting is in fact legal. While the author believes there is a clear argument for common law decanting in Texas, as long as there is no Texas statute or Texas case expressly authorizing it, decanting will necessarily include some ambiguity. Practitioners are well advised to proceed with caution and to consider other available techniques for trust modification when possible.

2. Statutory Decanting

Several states have passed statutes expressly authorizing decanting and specifying its parameters. Most of these statutes purport to codify and clarify the power to decant under the common law.

The various statutes are very similar in substance, though there are some key differences in the details of how and when decanting is permissible. Some of the statutes require that the distribution provisions under the existing trust give the trustee unlimited discretion, while other statutes allow decanting even when there is an ascertainable standard (e.g., distributions limited to health, education, maintenance, and support). Though there are very few cases (mostly in New York) interpreting decanting statutes, when there is an ascertainable standard and decanting is permissible, a new trust providing for distributions with the same or a more restrictive ascertainable standard should be okay. If the new trust widens the distribution standard such that any one or more beneficiaries can receive greater distributions, decanting to such a trust may be a breach of the trustee's fiduciary duty.

3. Issues and Considerations with Decanting

Whether decanting under the common law or pursuant to a statute, the trustee must be satisfied that the distribution powers of the trust would allow for decanting. Some trusts include specific provisions allowing for decanting, though few older trusts do. Also, a change in the beneficiaries of the trust can result in a breach of fiduciary duty unless there is specific authority under statute or the trust terms.

As discussed below, one of the strategies for trust modification may involve changing the trust situs and/or the governing law to another state. So, even if dealing with a Texas trust, the trustee may effectively be able to choose whether to decant under the common law or a particular state statute. There are a few special issues to consider when contemplating this decision.

If the existing trust contains an ascertainable standard, common law decanting may not be available. Some have argued that the applicable theory behind common law decanting – i.e., that the trustee with unlimited discretion holds a power of appointment (subject to fiduciary standards) – does not apply when the distribution provisions contain an ascertainable standard. The counter argument is that *any* discretionary distribution standard effectively is a power of appointment, even if some distribution standards are more restrictive than others. Because there is no clarity on this point under the common law, the trustee may be more hesitant to decant under the common law when there is an ascertainable standard. In such a case, it may be preferable to seek decanting pursuant to a particular state decanting statute that expressly allows decanting when there is an ascertainable statute, or to seek other ways of modifying the trust.

As discussed below, decanting and other types of trust modifications may give rise to certain transfer tax issues. Some of the more recent decanting statutes have express provisions intended to help shut down such transfer tax issues. Decanting under the common law may be more susceptible to those tax issues.

B. Termination By Distribution

Many trusts contain a provision expressly authorizing the trustee to terminate the trust and distribute its remaining assets to the trust beneficiaries if the trust is under a specified size or if, in the judgment of the trustee, continuance of the trust would be uneconomical. Even if no such provision is contained in the trust instrument, the trustee may have sufficient authority under the distribution provisions to make one or more terminating distributions. Texas Trust Code §112.059 expressly authorizes the termination of an uneconomical trust.

Of course, terminating the trust by distribution of the trust assets means that the assets no longer receive the protection from creditors, divorce, or transfer taxes that such assets may have had while in the trust. However, such loss of protection may be advisable when the trust is small, continued trust administration may be cost prohibitive, the trust provisions are burdensome, and/or the trust provisions may have failed to achieve protection from creditors, divorce, or transfer taxes due to some flaw in the drafting.

Accordingly, the practitioner should be sure to consider terminating the trust by distribution when presented with a case involving an unhappy trustee or beneficiaries.

C. Judicial Action

Texas Trust Code §112.054 provides the parameters and requirements for when and how a court may modify or terminate a trust. The statute was revised in 2005 to provide considerably broader standards for when a trust may be modified by the court.

Texas Trust Code §111.005 provides that common law rules still apply except to the extent the Texas Trust Code changes those rules. Therefore, Texas Trust Code §112.054 may not be the exclusive basis for a court to modify or terminate a trust. Under the common law, the court has significant power to modify a trust in order to give full effect to the settlor's intent.

Judicial action may sometime be necessary when no other option is available. Also, judicial action may be helpful to give cover to the trustee (if a release or indemnification is unavailable or inappropriate) or to utilize the ability of parents to represent their minor children when both are beneficiaries of a trust possessing the same beneficial interest without any conflict (i.e., virtual representation).

D. Merger (Combination)

Many trust instruments expressly allow the trustee to combine the trust assets with those of another trust and administer the combined trust estate either under the terms of that trust instrument or the trust instrument of the other trust. The scope of such merger provisions may enable the practitioner to draft a new trust with the desired provisions and then transfer the trust assets of the existing trust the new trust, to be administered according to its terms.

Even if the trust instrument does not expressly authorize the trustee to combine the assets of the trust with another trust, Texas Trust Code §112.057 allows it under certain circumstances and without judicial action. No consent of the beneficiaries is needed, though they do need to be notified.

E. Division of Trust

Texas Trust Code §112.057 also authorizes the trustee to divide a trust into one or more trusts without judicial action unless prohibited by the trust agreement and along as doing so does not impair the rights of any beneficiary or adversely affect the purposes of the trust. No consent of the beneficiaries is needed, though they do need to be notified.

This power may be particularly useful if different beneficiaries of a trust disagree about the administration or distribution of the trust. It can also be useful for dividing a trust that is partially exempt for GST tax purposes into 2 trusts – one that is wholly exempt and one that is wholly non-exempt. This allows for distributions to skip persons (e.g., grandchildren of the settlor) from the wholly exempt trust without incurring GST tax; it also allows distributions to non-skip persons (e.g., children of the settlor) from the wholly non-exempt trust without wasting the settlor's GST exemption.

F. Sale to New Trust

If a life insurance trust has been poorly administered, or if the settlor simply wants to modify the terms of the trust, the practitioner should consider a sale of the insurance policy held in the existing trust to a newly formed life insurance trust. The new trust is first drafted with the desired provisions and then is funded with sufficient cash to purchase the existing insurance policy from the existing trust. In most cases, the cash received by the old trust could then be distributed to one or more beneficiaries in termination of the trust because the cash value of the policy is typically not very great.

The new trust should be a grantor trust in order to avoid the application of the transfer-for-value rule. Under I.R.C. §101(a)(2), the sale of a life insurance policy generally results in the life insurance proceeds being subject to ordinary income tax upon the death of the insured; however, if the sale of the policy is to the insured, then the proceeds are excluded from income. Rev. Rul. 2007-13 makes clear that a sale to a grantor trust of which the insured is the grantor is treated the same as a sale to the insured.

G. Modification Or Termination By Agreement

Several Texas cases have held that the settlor and all the beneficiaries of a trust may agree to modify or terminate a trust without judicial action. The consent of the trustee is not necessary, though any modification which enlarges the duties of the trustee is likely effective without the trustee's consent.

If the settlor is dead or lacks legal capacity, this technique cannot be used. Likewise, if any beneficiary lacks legal capacity, it is not possible to rely on virtual representation, meaning again that this technique cannot be used. Court action or some other basis for modification would thus be required.

H. Change of Trust Situs (and Governing Law)

The situs of a trust is determined according to a number of factors, one of the most important of which is where the trustee is located. Even when the trust instrument expressly calls for the trust to be governed in accordance with Texas law, a conflict of laws analysis would hold that Texas law governs the *construction* of the trust agreement and the law of the trust situs governs the trust's *administration*.

Given that Texas does not have a decanting statute, it may be desirable to move the trust's situs to another jurisdiction (e.g., Delaware, Alaska, or New York which all have well thought out decanting statues) prior to decanting. Arguably, the appointment of a corporate trustee in another jurisdiction would effectively move the trust situs to that jurisdiction (assuming the corporate trustee does not also have offices in Texas). This same strategy could be used for other trust modification or trust termination techniques if they are more attractive outside of Texas.

I. Power of Appointment

If the trust instrument provides for an inter vivos power of appointment, the power holder can simply appoint the property to another trust with the desired terms. As long as the power holder is not a trustee, then no fiduciary duties apply (unlike decanting by a trustee which is done on the theory that the distribution power is a power of appointment exercisable in a fiduciary capacity).

J. Disclaimer

It is often possible for a beneficiary or even a trustee to disclaim certain unwanted powers, rights, or interests under a trust, thereby effectively modifying the trust terms and provisions. There are several drawbacks to this approach, chief among them being that the options for modifying the trust are usually very limited and the timing for making disclaimers has often long passed when modification is desired. Nonetheless, the practitioner cannot ignore this option when the right circumstances are present since it may be the easiest and least expensive means to eliminate unwelcome provisions in a trust instrument.

III. TAX ISSUES

While the article has thus far briefly discussed some of the more common ways to modify or terminate a trust, very little has yet been said about the tax consequences of any of those techniques. Often, a technique can be effective for modifying unwanted trust provisions though only at a high tax cost.

Accordingly, The practitioner must have a good handle on the relevant tax laws, particularly the transfer tax laws which can be quite tricky in the realm of trust modifications. While a detailed discussion of the relevant tax issues is beyond the scope of this article, what follows is a brief discussion of the main tax issues that can apply when modifying or terminating a trust.

Important Note: The IRS has issued IRS Notice 2011-101 requesting comments on the tax implications of certain trust decantings. The American College of Trust and Estate Council (ACTEC), the AICPA, and the State Bar of Texas Section of Taxation have all provided helpful comments in response to the IRS request (see end of article for references).

A. Gift Tax Issues

Whenever there is a shift in beneficial interest in a trust pursuant to any type of trust modification or termination, gift tax issues can arise. This concern can be heightened whenever a beneficiary consents to the trust modification or termination. Common scenarios when the issues arises include the beneficiary (i) agreeing to a trust modification (whether or not judicial action is involved), (ii) releasing or indemnifying the trustee who decants or otherwise agrees to the trust modification, and (iii) failing to object to a trust modification.

While the law is unsettled in this area, the author believes the vast majority of trust modifications do not involve truly concerning gift tax issues. The beneficiary has to have both donative intent and a legal power to make a gift. Unless the beneficiary has a general power of appointment or otherwise is entitled to trust property, the beneficiary most likely does not have legal powers over trust property.

For example, if the trust is modified pursuant to a decanting strategy, the modification is effected by the *trustee* pursuant to the trustee's distribution powers. Assuming the decanting power does not require the consent of the beneficiary, then whether or not the beneficiary agrees to the decanting is irrelevant. Additionally, if the trustee insists that the beneficiary release and indemnify the trustee before decanting, such release and indemnity does not therefore rise to the level of a legal power or imply donative intent. Simply put, there are other reasons to release and indemnify the trustee in that situation besides donative intent. Specifically, if the decanting is done pursuant to common law, the trustee may be fully satisfied it has the power to decant but unsure of the particular parameters and methods of carrying out that power. The release and indemnity would therefore serve the purpose of allowing the trustee to exercise the power to decant without being subject to question regarding the mechanics of how it is carried out.

One solution to any taxable gift concerns is to ensure the beneficiary holds a testamentary power of appointment over the new trust (or the beneficiary's portion of the trust). In that scenario, even if the beneficiary is deemed to have made a gift to the trust as a result of the trust modification, such gift would be incomplete for gift tax purposes. Any time a donor makes a gift to a trust and retains a power of appointment over that trust, the gift is incomplete and therefore not subject to gift tax. Note however while no gift tax would be due, the trust will likely be includible in the beneficiary's estate for estate tax purposes.

Many state decanting statutes expressly address these gift tax concerns.

B. Estate Tax Issues

The relevant estate tax issues are very similar to the gift tax issues mentioned above. When a beneficiary's interest is diminished as a result of the trust modification, the IRS could argue the beneficiary has made a transfer to a trust and retained a power over that trust (under I.R.C. §2036 or §2038). Likewise, if the settlor agrees to the trust modification (however achieved), the IRS could argue for inclusion in the settlor's gross estate. The applicable counter-arguments to any such IRS argument are similar to those described in the gift tax analysis above.

Of course, the new trust could erroneously give increased powers to the beneficiary that arise to the level of control that would cause estate inclusion. The attorney drafting the new trust must make sure not to give the beneficiary any such powers.

Many state decanting statutes expressly address these estate tax concerns.

C. GST Tax Issues

The trickiest transfer tax issues for any trust modification tend to be GST tax issues, particularly when dealing with a trust that is grandfathered from the GST tax (because it predates the inception of the GST tax laws on September 25, 1985) or the trust is GST exempt because GST exemption has been allocated to the trust.

If a *beneficiary* exercises a power of appointment over the trust, grandfathered status or otherwise GST exempt status should remain unchanged. However, if the *trustee* decants the trust or the trust is otherwise modified, the analysis can be much trickier.

I.R.S. Treas. Reg. §26.2601-1(b)(4)(i)(A) provides a safe harbor when a *grandfathered* trust is "modified" pursuant to a discretionary distribution (i.e., decanting). As long as the trust allowed for decanting when it originally became irrevocable and the new trust does not extend the trust beyond the rule against perpetuities (or 90 years, if greater), then grandfathered status will be retained. The question arises whether the common law allowed for decanting (if the express terms of the trust do not or if the trust pre-dates any applicable decanting statute). Most practitioners are uncomfortable relying on common law decanting for this safe harbor, so this safe harbor is generally considered available only if the trust instrument expressly authorizes decanting.

I.R.S. Treas. Reg. §26.2601-1(b)(4)(i)(D) provides a safe harbor when a *grandfathered* trust is modified in any manner whatsoever (including decanting). As long as the new trust does not cause a beneficial interest to be shifted to a beneficiary in a lower generation and does not extend the trust beyond the rule against perpetuities (or 90 years, if greater), then the grandfathered status will be retained.

While there are no express safe harbors applying to trusts which are GST exempt as a result of allocation of GST tax exemption (as opposed to grandfathered trsuts), the IRS has indicated that the regulations dealing with grandfathered status (including the safe harbors described above) are relevant by analogy.

It is important to note that loss of grandfathered or GST exempt status may not matter in many cases where the trust would already terminate in favor of a beneficiary (and thus be subject to estate tax) or if the trust is likely to be spent down on behalf of the beneficiaries prior to any taxable event.

D. Federal Income Tax Issues

Generally, a trust modification by decanting or otherwise will be a nonrecognition event for income tax purposes, as long as the beneficiaries' interests remain substantially unchanged. Furthermore, when a distribution is made from the original trust to the new trust pursuant to decanting, it appears that the new trust will be treated as the very same trust as the original trust for income tax purposes (therefore keeping the same tax identification number and tax attributes).

Any trust modification (including via decanting) involving a switch from a grantor trust to a non-grantor trust, or vice versa, may cause a realization event for income tax purposes or other income tax consequences. The best arguments state otherwise, though prudence would suggest that the new trust have the same income tax status as the original trust until the IRS provides definitive guidance.

IV. CASE STUDIES (A.K.A. WAR STORIES)

A. Clean-Up Poorly Administered Insurance Trust

Client had a life insurance trust for the benefit of his wife. The trust had been funded with community property for several years, meaning that a portion of the death benefit would be deemed to have been contributed by client's wife and therefore includible in her estate for estate tax purposes.

The trust also had undesirable provisions, including a trust for son after wife's death that would terminate and pass outright to son at age 30 (rather than stay in trust for son's lifetime). Also, the successor named trustees (after wife) were no longer acceptable, and there were no options for appointing different trustees other than by court action.

The policy had a cash value of approximately $120,000 and a death benefit of $4,000,000. Client wanted to keep $4,000,000 of insurance in place but was uninsurable. Letting the original policy lapse and replacing the coverage with a new policy in a new insurance trust was therefore not possible.

No GST tax exemption had been allocated during the first 5 years of the trust. Client's GST exemption was automatically allocated over the following 4 years due to the passage of the Economic Growth and Tax Relief Reconciliation Act in 2001. Accordingly, the trust was partially exempt from the GST tax.

The client was able to "modify" the trust provisions governing the insurance policy without the necessity of judicial action. The trustee of the existing trust pulled most of the cash value out of the existing policy, leaving the cash surrender value at approximately $20,000. The client created a new insurance trust and funded it with sufficient cash to purchase the existing policy from the existing trust. The client used his annual exclusions in December and in January to fund the requisite cash into the new trust (i.e., the new trust contained Crummey withdrawal rights, thus qualifying the gifts to the new trust for the annual exclusion).

The new trust was designed as a grantor trust in order to avoid the transfer for value rule (discussed under "Sale to New Trust" above). The client allocated GST exemption to the trust to make it wholly exempt from the GST tax.

After the sale of the insurance policy to the new trust, the existing trust had $120,000 of cash (i.e., $100,000 from pulling the cash value out of the policy prior to the sale, plus $20,000 from the sale of the policy to the new trust). The terms of the original trust allowed for distributions to client's wife and son. Some of the cash was used to pay for current education expenses for client's son and other cash was used to pay certain living expenses for wife.

B. Clean-Up Messy Tax Status

Client and client's husband created a life insurance trust for their three children. The trust held a second-to-die insurance policy on the lives of client and husband with a cash value of approximately $500,000 and a death benefit of $1,500,000. Husband died a few years earlier. At husband's death, the trust was partially exempt from the GST tax due to lack of exemption allocation prior to the 2001 tax act followed by automatic allocation of GST tax exemption after the 2001 tax act. At husband's death, husband was transferor (for GST tax purposes) as to 50% of the trust and client was transferor (for GST tax purposes) as to 50% of the trust. After husband's death, client continued to fund the trust with cash gifts in order to pay the insurance premiums, meaning that client was transferor (for GST tax purposes) for greater than 50% of the trust. A calculation was performed, and it was determined that client was transferor (for GST tax purposes) as to 65% of the trust.

A corporate trustee was then serving, and client was very happy to have them continue to serve as trustee. Client did however desire to clean up the GST tax status of the trust and to modify the terms of the trust to give her children powers of appointment over their own trusts (after her death). This was particularly important to her unmarried daughter who was very charitably inclined and desired the flexibility to appoint some or all of her portion of the trust to charities at her death.

The solution ultimately chosen was to have client allocate GST exemption to the existing trust to the full extent that she was transferor for GST tax purposes (i.e., 65% of the trust value). Then, the trustee performed a qualified severance of the existing trust for GST tax purposes pursuant to Section 2642(a)(3) of the Internal Revenue Code and Section 112.057 of the Texas Trust Code, thus dividing the existing trust into a wholly exempt trust and a wholly non-exempt trust.

The trustee then decanted the trust property (i.e., the insurance policy) to a newly created insurance trust with two separate shares – an exempt trust and a non-exempt trust. It was determined that decanting was available under common law. The new trusts held substantially the same distribution provisions, including the very same ascertainable standard. Client's children were given testamentary powers of appointment over their respective shares of the trusts (both for substantive reasons so they could have flexibility over their own shares and to avoid any potential gift tax).

Client, trustee, and client's children all signed an agreement calling for the distribution of the trust assets from the original trusts (i.e., after the qualified severance) to the new trusts and releasing and indemnifying the trustee for its actions.

C. Clean-Up Poorly Drafted Trust

Client's father created and funded a joint revocable living trust with client's mother during the joint lifetime. Mother died in 2002. The revocable living trust was from a "do-it-yourself" kit with purported tax planning of dubious quality. Things were made worse when father and mother added some special drafting to "make the trust a little better".

At mother's death, a portion of her one-half community property interest was supposed to pass into a credit shelter trust for father's benefit. However, all of the trust property remained in the name of the joint living trust as the credit shelter trust was never funded. Father was the trustee of both the joint living trust and the credit shelter trust but had recently become permanently incapacitated.

No successor trustee was named and no mechanism for appointing a successor was provided under the trust instrument. The original trust agreement had been lost, and all that remained was a copy that was missing a few pages.

Client was one of three adult children who all got along very well. Client held father's powers of attorney for health and financial purposes and was the point person for all of father's affairs. Father's assets were tied up in the trust and many of his bills were overdue. Client had been paying father's bills out of her own funds but could not continue to do so much longer.

Client filed a petition in Collin County (father's domicile and the situs of the trust) on behalf of father pursuant to his power of attorney and on behalf of herself as a remainder beneficiary of the trust. The petition sought to modify the trust by amending and restating it in its entirety. The requested trust modification eliminated the tax planning (father had approximately $800,000 in assets and needed no estate tax planning), appointed client as trustee (without the possibility of compensation), and appointed client and her siblings to a trust committee with the power to remove the trustee and appoint successor trustees.

Client's siblings joined with client in requesting the trust modification. The adult grandchildren also joined in the requested relief. No guardian ad litem was appointed by the court because minor grandchildren's interests were properly represented by client and client's siblings (i.e., via virtual representation).

All of the requested changes either were administrative in nature or were substantive changes that served only to (i) preserve the value of the trust, (ii) clear up ambiguity under the trust agreement, (iii) eliminate unnecessary (and poorly drafted) tax planning, or (iv) improve father's access to trust funds.

The author sent an order to the court under a cover letter explaining the situation and requesting that the court sign the order without a hearing. Approximately one week later, the court signed the order.

D. Eliminate Corporate Trustee Requirement

Client was the beneficiary of a trust established by her father with closely held company stock initially worth approximately $5,000,000. The trust was established when client was a minor, and the trust required a corporate trustee. The trust also included significant special drafting to protect trust assets in the event client ever became a "bad apple". Client was the sole beneficiary of the trust during her lifetime, with her children as equal remainder beneficiaries at her death.

Over client's lifetime, the trust had been spent down properly on behalf of client, and only approximately $800,000 remained in the trust. The corporate trustee and client's adult children all agreed that client was in fact not a "bad apple" and that the corporate trustee requirement (which was put in place mainly to ensure the special drafting was applied) was no longer necessary. Everyone agreed client would most likely spend down the trust during the remainder of her lifetime, with or without the payment of trustee fees.

Client desired a trust modification to eliminate the corporate trustee requirement and appoint client as trustee, thereby eliminating trustee fees.

Before the petition was ever filed, the author consulted with the corporate trustee and its attorney to explain client's desire and to determine whether the corporate trustee would oppose the petition. The requested modification was administrative in nature and would save trustee fees. Though client's desire to serve as trustee had the potential work to the detriment of the remainder beneficiaries if client administered the trust poorly, the corporate trustee ultimately joined in requesting the trust modification after assessing all of the facts. The corporate trustee had a long track record with client and clearly saw that the trust would be spent down during client's lifetime for reasonable living expenses, unless client died prematurely. The corporate trustee also interviewed client's children carefully and determined they in fact desired that client serve as trustee.

Client filed a petition in district court seeking the trust modification. Client's children consented to the requested trust modification. No guardian ad litem was appointed by the court because minor grandchildren's interests were properly represented by client's children (i.e., via virtual representation).

After all answers were filed with the court joining in requesting the relief sought in the petition and the court determined no guardian ad litem was necessary, all parties signed an agreed order. Though a hearing had been set several weeks out (the earliest possible date), the author personally went to the courthouse with the agreed order and a letter explaining the situation. The court signed the agreed order that same day.

E. Planned Flexibility For Tax Law Uncertainty

Over the last 2 years, many clients sought to "lock-in" the use of their $5,000,000 gift tax and GST tax exemptions before the feared drop in those exemption at the end of 2012 (which ultimately did not happen). Accordingly, many clients had an incentive to make very large gifts earlier than they might otherwise have desired. Many of these clients were in their 40's and 50's and unsure about many things that typically affect such planning, including how much they might need over their lifetime and how their children might turn out.

The planning community responded with solutions that maximized flexibility in the irrevocable gift trusts they helped clients create. One technique was to have one spouse give property to a trust for the benefit of the other spouse and include a power of appointment in the donee spouse to change the terms of the interests ultimately passing to the children. Often, those spousal gift trusts contained an express decanting provision or at least a wide open distribution power in an independent trustee that would enable decanting.

In one case towards the end of 2012, with the clock winding down on the window of opportunity to "lock-in" the higher exemptions (so we thought), one client wanted to make gifts to each of her 5 children in disproportionate amounts (for reasons irrelevant here) but needed special drafting in 3 of those children's trusts. Instead of rushing to draft those 5 trusts, client instead created a single trust for the benefit of her husband and 5 children and gave her husband an inter vivos special power of appointment expressly allowing him to appoint the property disproportionately among the children outright or in further trust. The trust also gave an independent trustee an express decanting power to achieve the same desired result in the event husband happened to die prematurely.

In addition, virtually all of the gift trusts the author created in 2011 and 2012 (and now also in 2013) are grantor trusts for income tax purposes. However, grantor trusts are currently in the crosshairs of many politicians in Washington who would like to see the estate tax laws changed so that the powers triggering grantor trust status would also cause estate inclusion.

While it is anticipated that any future legislation which negatively affects existing trusts would provide for grandfathered status of those existing trusts, it is best to build flexibility into irrevocable trusts in order to address unforeseen circumstances. The author fully expects to rely on many such flexibility provisions to "modify" recently created trusts over the next 5 to 30 years. More on the types of flexibility provisions is said under the "Drafting Considerations" section below.

F. Planned Flexibility For Asset Protection

In one recent case, client had certain asset protection concerns (in addition to a desire to lock-in current gift tax and GST tax exemptions) but did not wish to establish a non-Texas trust. Client thus established a Texas gift trust for wife for both tax and asset protection purposes. The trust provisions included the flexibility to decant the trust to a non-Texas jurisdiction, such as Delaware or even offshore. While decanting at a time when creditors are knocking on the door would certainly not be ethical or legal, client has preserved the ability to move the trust assets in the future at a time before such movement would be prohibited.

The same flexibility can be very desirable going in reverse (i.e., from Delaware or offshore back to Texas). Many clients who may be uneasy about establishing a trust outside of Texas will feel more at ease knowing such trust could be easily brought back to Texas when asset protection concerns no longer exist (e.g., retirement) or if it turns out the client dislikes the non-Texas trust after experiencing it for a time.

V. DRAFTING CONSIDERATIONS

Though there are many techniques available to modify irrevocable trusts when necessary, the best practitioners should at least consider incorporating certain provisions to make future modifications easier. Practitioners should also consider incorporating provisions that *prohibit* certain types of modifications if the client is worried that the beneficiaries will attempt to undo the careful planning the client built into the trust.

What follows are sample of are some of the provisions for the author has found most useful to date. Use at your own risk!

A. Decanting Provisions

"Distributions to Trusts. The Trustee is expressly authorized and has full discretion to direct the payment of any part or all of the trust estate of this trust (the "original trust") to the trustee of any other trust created for the benefit of any one or more of the beneficiaries described under this Subsection ___ (such other trust shall be referred to as the "recipient trust"), provided, however, that (i) the recipient trust does not direct or permit payments to or applications by the trustee for the benefit of any person other than one or more of the beneficiaries described under this Subsection ___ of the original trust, (ii) the recipient trust does not reduce any fixed income interest of any income beneficiary of the original trust, (iii) the recipient trust ends no later than the perpetuities date of the original trust, and (iv) the Trustee gives each beneficiary of the original trust written notice of the Trustee's intention to make such direction at least thirty (30) days before making the direction. For purposes of clause (i) of the preceding sentence, the beneficiaries of the original trust shall include all beneficiaries described under this Subsection ___, whether original discretionary beneficiaries, income-only beneficiaries, or remaindermen, and for purposes of clause (iv) of the preceding sentence, the beneficiaries of the original trust shall include only those descendants of Settlor and Settlor's Spouse who are then legally competent. Notwithstanding the first sentence of this section, the terms of the recipient trust may provide any one or more of the beneficiaries described under this Subsection ___ with a power of appointment exercisable in favor of any one or more individuals, regardless of whether any such individual is a beneficiary of the original trust.

B. Prohibition of Decanting

"Notwithstanding anything herein to the contrary or any power granted to a Trustee under applicable law, a Trustee who is authorized to make distributions to or for the benefit of a beneficiary shall not exercise that power by appointing all or part of the principal of the trust subject to the power in favor of a trustee of another trust for the benefit of one (1) or more of the beneficiaries under the same trust instrument or under a different trust instrument."

C. Distribution Trustee

The following language was used in a trust created by husband for the benefit of wife and children. It gives an independent trustee (i.e., the distribution trustee) the power to distribute property unequally among wife, children (or existing Children's Trusts), and charities, thereby preserving a large amount of flexibility. Husband has the ability to appoint a distribution trustee at any time. A trust committee (consisting of 3 independent individuals) has the power to add any one or more charities as permissible beneficiaries of the trust – a power that makes the trust a grantor trust and also enables clients to use the trust property to help charities if they so desire in the future.

"3.1D Distributions By a Distribution Trustee. A Distribution Trustee, when one is serving, may make distributions of income or principal from the Common Trust in accordance with the following provisions:

1. Distributions to Settlor's Spouse and to Descendants. The Distribution Trustee may distribute to Settlor's Spouse and/or to the descendants of Settlor and Settlor's Spouse, or to any trust or trusts created for any such beneficiaries (including, without limitation, any one (1) or more of the Children's Long-Term Trusts), as much income or principal of the Common Trust as will provide for the beneficiaries' health, support, maintenance, education, welfare, comfort, and happiness or for any other purpose, and in such amounts, as the Distribution Trustee deems advisable in its sole and absolute discretion, with or without regard to any other income or financial resources known to the Distribution Trustee to be available to the beneficiaries.
2. Distributions to Charities. If any one (1) or more Charities is added to the class of permissible beneficiaries of this trust pursuant to the provisions of Section 4.1 hereof, then the Distribution Trustee may distribute to any one (1) or more of those Charities as much income or principal of the trust as the Distribution Trustee deems advisable in its sole and absolute discretion.
3. Unequal Distributions Expressly Permitted. The Distribution Trustee is expressly authorized and has full discretion to make unequal distributions under the foregoing provisions of this Subsection, including distributions that exhaust the trust to any one (1) or more beneficiaries without making distributions to other permissible beneficiaries hereunder. Any distributions under this Subsection 3.1D to a beneficiary shall be charged against the trust estate as a whole and not against the ultimate distributive share of that beneficiary. The Distribution Trustee shall not be liable for exercising its discretion under these provisions."

D. Trust Protector

The following language was used in a Delaware Trust set up by client for asset protection purposes.

"(b) Role and Function. The Trust Protector shall have the following roles, powers and duties:

(1) To amend the administrative and technical provisions with respect to any trust created by or pursuant to this Agreement in accordance with Article FIFTEENTH of this Agreement, at such times as the Trust Protector may deem appropriate for the proper administration of the Trust and for tax purposes. In particular, the Trust Protector shall have the power to modify or amend the provisions of this Agreement to ensure that this Agreement is a qualified disposition under the Delaware Qualified Dispositions In Trust Act, 12 Del. C. § 3570, et. seq. (the "Act"). Prior to amending the Trust in accordance with the provisions hereof, the Trust Protector shall consult with the Trustee as to the advisability of any such amendment provided however that the Trust Protector shall at all times have the sole and absolute discretion to amend the Trust as set forth in this section (b)(1).

(2) To designate the law of any jurisdiction (under which the terms of any trust created by or pursuant to this Agreement shall be capable of taking effect) to be the governing law of any trust created by or pursuant to this Agreement, as provided in Article TWENTIETH of this Agreement.

(3) To direct the Trustee to elect that any property passing into the Marital Trust be treated as qualified terminable interest property for the purposes of qualifying for the marital deduction as provided in Article FIRST section (d)(5) of this Agreement. The Trust Protector shall consult with the Trustee prior to directing the Trustee to make the election set forth herein provided however that the Trust Protector shall at all times have the sole and absolute discretion to direct the Trustee to make such election.

(4) To remove and replace the Trustee as provided in Article SIXTEENTH of this Agreement, provided that at all times the situs of any trust created by or pursuant to this Agreement is in the State of Delaware, there shall be a "Qualified Trustee" as defined in the Act.

(5) To remove any Investment Direction Adviser and appoint additional and successor Investment Direction Advisers as provided in Article NINTH of this Agreement.

(6) To appoint an initial Distribution Adviser (other than the Grantor or other prohibited persons)

and to remove any Distribution Adviser and appoint additional and successor Distribution Advisers as provided in Article TENTH of this Agreement.

(7) To enter into fee agreements with the Trustee, Investment Direction Adviser and Distribution Adviser.

(8) To require an accounting by the Trustee, setting forth the receipts, disbursements, and distributions of both principal and income during the period of accounting and the invested and uninvested principal and undistributed income that is in existence at the beginning and at the end of such accounting period. The Trust Protector shall further have the power, exercisable at any time, to examine all records maintained by the Trustee for any trust created by or pursuant to this Agreement including, but not limited to, trust documents, minutes, books, accountings and tax returns.

(9) To require the Trustee, Investment Direction Adviser, Distribution Adviser, or any person or entity to whom the Trustee, Investment Direction Adviser or Distribution Adviser has delegated a power pursuant to this Agreement, be required to give a bond or other security for the faithful administration of its or their duties under this Agreement; provided, however, that the amount of any such bond or other security shall be in an amount that is reasonably attainable by such person or entity."

E. Invter Vivos Power of Appointment

The following language was used in a trust created by husband for wife's primary benefit. It requires the consent of independent parties to the exercise of the power of appointment by wife, though no such consent is necessary for tax or asset protection purposes.

"Inter Vivos Special Power of Appointment. At any time during Settlor's Spouse's lifetime, the Trustee shall distribute the entire trust estate, or any part thereof, to the limited class consisting of the descendants of Settlor and Settlor's Spouse, in those amounts and proportions and upon those terms and conditions, either outright or in trust, as Settlor's Spouse shall have appointed by an acknowledged instrument signed by Settlor's Spouse after the date of this instrument and filed with the Trustee and in the Deed Records of Dallas County, Texas that specifically refers to this special power of appointment and expresses the intention to exercise it. The special power of appointment granted under this subsection shall not be (a) construed as authorizing Settlor's Spouse to appoint to Settlor's Spouse, Settlor's Spouse's creditors, Settlor's Spouse's estate, or the creditors of Settlor's Spouse's estate; (b) exercisable in a manner that will violate the rule against perpetuities or any other law restricting the period of time for which property may validly be held in trust; (c) exercisable by Settlor's Spouse with respect to any life insurance policy on the life of Settlor's Spouse that is part of the trust; or (d) exercisable by Settlor's Spouse to discharge any of Settlor's Spouse's legal obligations, including, without limitation, Settlor's Spouse's legal obligations to support any beneficiary of the trust. Notwithstanding the foregoing, Settlor's Spouse may not exercise the special power of appointment granted under this subsection without obtaining either (i) the written consent of an Independent Trustee if one is then serving (or a Distribution Trustee if one is then serving) or (ii) the written consent of the Trust Committee.

F. Provisions For Change of Situs or Governing Law

"10.5 Law Applicable. The validity, construction, interpretation, and administration of this trust shall be governed by the laws of the State of Texas, subject to the following provisions:

A. Change of Controlling Law and Situs. An Independent Trustee, when one is serving, shall have the power, with the consent of a majority of the members of the Trust Committee, to designate the law of any other state within the United States of America to be the governing law of any trust created hereunder, and to declare that such trust shall thereafter be governed by and take effect according to the laws of the jurisdiction so designated, the courts of which shall become the forum or situs for the administration of such trust, as well as all matters applicable to the administration thereof. After any such declaration by the Independent Trustee, any requirement under the terms of this instrument that a document be filed in the Deed Records of Dallas County, Texas shall instead be read to require such document be filed in the Deed Records of the county of the capital of the state to which the situs has been changed.

B. Manner of Making Change. Such designation and declaration with respect to any trust created hereunder shall be set forth in a deed or other written instrument delivered to Settlor, Settlor's Spouse, and each adult beneficiary of such trust to whom current distributions of income from such trust may be made, which instrument shall contain the powers and provisions that are necessary to enable such trust to be capable of taking effect under the laws of such jurisdiction.

C. Effective Date. Upon the declaration by the Independent Trustee that any trust created by or pursuant to this instrument shall be governed by and administered in accordance with the laws of a new jurisdiction, the rights of all persons, parties, and entities, and the construction, effect, and administration of each and every provision of such trust shall be subject to and construed only according to the laws of the designated jurisdiction."

VI. FOR FURTHER READING

The author has attempted to provide a broad overview of certain tips and techniques available for uncontested trust modifications. The goal has been to inform the reader about the available options and provide generalized warnings about the various tax and other implications of those options, to help the reader narrow down the range of options worth considering in more detail in any particular case. Some of the more technical papers currently available that have been most helpful to the author are as follows:

- Melissa J. Willms, "Decanting Irrevocable Trusts," Texas Tax Lawyer (Fall 2012).
- Eric Reis, "Irrevocable or Not? Modifications to Trusts," 33rd Annual State Bar of Texas Adv. Est. Planning and Prob. Course (2009)
- Glenn Karisch, "Modifying and Terminating Irrevocable Trusts," 23rd Annual State Bar of Texas Adv. Est. Planning and Prob. Course (1999) (updated version at www.texasprobate.net)
- Michael Gordon, et al, "The Tax Consequences of Decanting: An Overview of the Gist Estate, Income, and Generation-skipping Transfer Tax Issues to Consider When Contemplating a Trust Decanting," 19rd Annual State Bar of Texas Adv. Est. Planning Strategies Course (2013)
- Mark Sale and Phil Lindquist, "Trust Modification: Helpful Techniques to Fix What is Broken," Estate Planning Council of Central Texas (2008).
- William R. Culp, Jr. and Briani Bennett Mellen, "Trust Decanting: An Overview and Introduction to Creative Planning Opportunities,"45 Real Property, Trust, and Estate Law Journal (Spring 2010), pp. 1-52.
- Meryl G. Finkelsteain, "Trust Decanting: Tax Consequences," Strafford Publications Webinar, February 19, 2013.
- The American College of Trust and Estate Council (ACTEC) letter to the IRS dated April 2, 2012 re: Comments of the American College of Trust and Estate Counsel on Transfers by a Trustee From an Irrevocable Trust to Another Irrevocable Trust
- AICPA letter to the IRS dated June 26, 2012 re: Comments on Notice 2011-101 regarding Transfers by a Trustee From an Irrevocable Trust to Another Irrevocable Trust.
- State Bar of Texas Section of Taxation letter to the IRS dated May 22, 2012 re: Comments of the State Bar of Texas, Tax Section on Transfers by a Trustee from an Irrevocable Trust to Another Irrevocable Trust