Trust Modification Under the Uniform Trust Code

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There are two sure things in life – death and taxes, but there is actually a third, and that is change. Since the early 2000's, the federal estate tax changed – drastically; moreover, while death is certain, the timing of death is not. This means that estate plans we put together years ago, need to be updated from time to time to reflect ever-evolving tax and substantive laws and changes in family circumstances. Updating is no problem when you are dealing with a live, mentally competent person's will or revocable living trust, but it becomes more complicated when you are dealing with an irrevocable trust. This is true even if the grantor or settlor (hereinafter referred to as the "settlor") of the irrevocable trust is still alive, but it is especially true when the settlor is deceased.

This presentation will provide an overview of the multiple options we have as estate planners to adjust irrevocable trusts, by considering possible alternatives based on the language in the existing documents, and outlining nonjudicial and judicial options available under the Tennessee Uniform Trust Code, with references to Alabama's, Kentucky's and Mississippi's Uniform Trust Codes.[1] This presentation will also explore various considerations when choosing the method of modification, including limitations in the underlying document, agreeability of the qualified beneficiaries, fiduciary duty, case law and IRS rulings and regulations.

A. Modification Incorporated in the Documents Themselves:

1. General and Limited Powers of Appointment.

We are all familiar with provisions that allow a trust beneficiary to redirect the income and/or principal of a trust in which the individual is a beneficiary to another individual or

[1] Where possible references, comparisons and contrasts are made among the relevant laws of Tennessee, Mississippi, Kentucky and Alabama; however, due to the nature of Louisiana law, the presenters chose to refrain from commenting on that State's laws, and at times also limited discussion of a particular statute to Tennessee's law.

entity in whatever manner the power provides; such provisions grant the beneficiary a power of appointment, and the powers can be inter vivos (exercisable during the beneficiary's life) or testamentary (exercisable in the beneficiary's Will), or both. General powers of appointment give the beneficiary the power to appoint to whomever the beneficiary pleases, including the beneficiary, the beneficiary's estate and/or his or her creditors. A general power of appointment is granted even if the document only authorizes the beneficiary to appoint property to his or her creditors. A limited power of appointment is exercisable only in favor of persons or a certain class of persons designated in the document granting the power, other than the beneficiary or his or her estate or creditors. Estate planning documents often grant special powers of appointment that cannot be exercised in favor of the beneficiary holding the power, the beneficiary's estate, or the beneficiary's creditors. See **Exhibit A** with sample language for general and limited powers of appointment.

If the irrevocable trust gives the beneficiary a power of appointment, then such power may be exercised in accordance with its terms to adjust the distribution of the trust property to better reflect changed circumstances. For example, surviving wife, who is a beneficiary under an irrevocable trust left for her when her husband died years before, could exercise the limited power of appointment given to her with regard to the couple's children to redirect all or a portion of the trust assets to a special needs trust for the benefit of one of the couple's children, who since the date of father's death has become disabled and dependent on government assistance.

Caution must be taken when exercising a power of appointment to recognize any restrictions or limitations to the class of persons for whom the power can benefit. Should a power of appointment name a person not within the permissible class of persons the gift will fail. Moreover, when exercising the power, the beneficiary must make sure to do so in full accordance with the granting document without violating the applicable rule against perpetuities.

2. Power to Appoint and Remove Trustees.

Often included in the instrument section naming the trustee and successor trustees are provisions that direct the manner of removing a trustee and/or appointing trustees, successor trustees and co-trustees in the event that a trustee is removed, resigns or no longer is able to serve.

Such provisions allow those granted the right to remove and appoint the power to adjust the trustee(s) if necessary, which in turn may be an important step in the process of modifying an outdated trust. This may be the case where a corporate trustee is serving but unresponsive to changing circumstances. Those with the power to appoint and remove trustees may be able to remove the corporate trustee and appoint a more responsive trustee, who then may be able to modify the trust as desired. Again, caution must be taken to comply with the terms of the instrument regarding who is entitled to serve as trustee.

3. Small Trust Provisions.

Incorporated into some wills and trusts is a provision that gives the trustee authority to terminate a trust if the value of its property is too low to justify the cost of administering the trust; such language may appear as follows:

"If the principal and undistributed income of any trust shall at any time be less than an amount which the Trustees . . . deem practical for continuance of the trust, such Trustees may, in their discretion, terminate the trust by distributing all of the then remaining principal and undistributed income to the person or persons to whom the income payments of the trust could be made, such persons, if there be more than one, to take *per stirpes*."

Such a provision can be relied on to avoid establishing a trust for a further beneficiary after the death of a lifetime beneficiary, if he or she was unable to exercise his or her power of appointment or where no power of appointment was granted, when the trust for the further beneficiary is no longer necessary (i.e., due to the beneficiary's age or improved circumstances) or when the trust property truly has dissipated, making a further trust impractical. To avoid giving a trustee a general power of appointment, such provisions often require a trustee other than a trustee who is a beneficiary of the trust affected by the provision to make the determination and take the steps of termination; this is where the "Power to Appoint and Remove Trustees" discussed above may be important in the adjustment process.

4. Decanting Language.

Discretionary language in the distribution provisions of a document may provide another method of modifying an outdated trust. "Decanting is the act of a trustee exercising its power to distribute trust principal to or for the benefit of a beneficiary by distributing the assets to a new trust." ("Decanting Comes Of Age," Aghdami, Farhad and Daniel J. Durst of Williams Mullen, paper revised February 12, 2018.) The language at the foundation of such power may read as follows: "The Trustee may distribute all or any portion of the net income and principal of the trust to any one or more of the group consisting of the child and the child's issue in such amounts and at such times as the Trustee, in the Trustee's discretion, may determine." When decanting, the trustee instead exercises the trustee's authority to distribute income and/or principal by appointing all or part of the income and/or principal of the trust in favor of the trustee of another trust. This option will be explored further when nonjudicial methods for adjusting trusts under the Uniform Trust Code are discussed below, but it is important to note that use of this method first requires careful review of the underlying document, as the language in the document may prevent the use of this tool even if the Uniform Trust Code allows it.

5. Merger and Division Language.

Likewise, language in the trust instrument may permit the trustee to add the assets of any trust established under the will or trust instrument to the assets of any other trust established under the same instrument or to the assets of any trust established outside of the will or trust instrument and to administer them as one trust. Again, it is important to read the provisions granting such power to the trustee to determine if any restrictions or qualifications are given regarding the merger. For instance, does the merger power require the beneficiaries of the two trusts to be identical; does it require the trustees to be the same? Merging two trusts, even with substantially similar terms and for the same beneficiary, may make good sense to obtain synergy in investing trust assets, to reduce trustee fees by putting more funds under management, and to reduce accounting fees.

Similarly, provisions in the trust instrument may allow the trustee to separate trust property into separate shares or trusts to achieve a specific purpose; typically, the purpose to be achieved relates to certain tax benefits. For example, dividing a trust into two trusts for GST tax

purposes so that one such resulting trust has an inclusion ratio of one and the other has an inclusion ration of zero, or dividing a trust into two trusts for the purpose of electing a marital deduction for one trust but not for the other. Even if the instrument does not provide for merging or separating trusts, the Uniform Trust Code does, and this will be discussed further below.

6. Trust Protectors and/or Trust Advisors.

A trust protector or trust advisor, under the Tennessee Uniform Trust Code, is a person who is not a trustee, but who under the terms of the instrument, has powers or duties with respect to the trust. Such powers or duties may include, but are not limited to:

(i) the power to modify or amend the trust instrument to achieve favorable tax status or respond to changes in any applicable federal, state, or other tax law affecting the trust,

(ii) the power to amend or modify the trust instrument to take advantage of changes in the rule against perpetuities, laws governing restraints on alienation, or other state laws restricting the terms of the trust, the distribution of trust property, or the administration of the trust,

(iii) the power to change the governing law or principal place of administration of the trust,

(iv) the power to remove a trustee, co-trustee, or successor trustee, and appoint a successor,

(v) the power to increase or decrease any interest of the beneficiaries in the trust, to grant a power of appointment to one or more trust beneficiaries, or to terminate or amend any power of appointment granted in the trust,

(vi) the power to appoint (i.e., decant),

(vii) the power to terminate all or part of a trust, and/or

(viii) the power to veto or direct all or part of any trust distribution.

Tennessee Code Annotated (T.C.A.) §35-15-1201; see also, Miss. Code Ann. §91-8-1201, which is substantially similar to Tennessee's statute. By contrast, Kentucky and Alabama appear to rely on KRS §386B.8-080 and Ala. Code 1975 §19-3B-808, respectively, both of which grant powers to direct. Tennessee and Mississippi also have powers-to-direct statutes found at T.C.A. §35-15-808 and Miss. Code Ann. §91-8-808, although the provisions of Tennessee's power to direct statute "diverge significantly from the Uniform Trust Code and the restatements." (2013 Restated Comments To Official Text of T.C.A. §35-15-808.) Copies of the relevant statutes for Tennessee, Mississippi, Alabama and Kentucky are attached as **Exhibit B.**

As noted above, such powers are typically granted in the instrument creating the trust; however, a court may order or the qualified beneficiaries may also agree to authorize a trust protector or trust advisor to exercise any such power or duty with respect to a trust. Naming a trust protector or trust advisor in a will or trust to exercise any such powers or duties provides a means of adapting an irrevocable trust to changing circumstances or laws. For example, in a special needs trust, it is wise to name a trust protector who has the power to modify, reform or amend the terms of the trust to respond to changes in the law that adversely affect the beneficiary's right to receive services and benefits that the beneficiary is currently receiving or may receive in the future from any local, state or federal government or private agency for the beneficiary's special needs.

7. Power to Modify for S Corporation Stock.

An entity's S corporation election may be jeopardized when a shareholder dies and his or her interest in the corporation is transferred to a trust that is not eligible to be a shareholder. Often language is incorporated in the power provisions of a will or trust which allows a trustee the power to modify an irrevocable trust so that it can elect to be treated as a qualified subchapter S trust, thereby qualifying as a shareholder of S corporation stock, or which allows a trustee the power to establish a separate trust to hold just the S corporation stock for purposes of qualifying

the same as an S corporation shareholder. ("Making a Trust an Eligible S Corp. Shareholder: QSST and ESBT Elections," Siddiqui, Sid, November 1, 2014.)

B. Modification Under The Tennessee Uniform Trust Code:

1. Nonjudicial Methods for Modification.

(a) Nonjudicial Settlement Agreements

(T.C.A. §35-15-111) – Under the Tennessee Uniform Trust Code, the trustee and the qualified beneficiaries of a trust may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust, to the extent that such an agreement does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court under the statute or other applicable law. Mississippi's Uniform Trust Code also allows the trustee and qualified beneficiaries to enter into such an agreement (Miss. Code Ann. §91-8-111); however, Kentucky's and Alabama's Uniform Trust Codes provide that "interested persons" may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust. (Ala. Code §19-3B-111 and KRS §386B.1-090.) Both Codes define "interested persons" as "persons whose consent would be required to achieve a binding settlement were the settlement to be approved by the court." (KRS §386B.1-090(1).)

All of these statutes provide a non-exhaustive list of matters that may be resolved by a nonjudicial settlement agreement; copies of the relevant statutes for Tennessee, Mississippi, Alabama and Kentucky are attached as **Exhibit C**. Examples of matters that can be resolved by nonjudicial settlement agreement include: (1) interpretation or construction of the terms of the trust; (2) approving the report or accounting of a trustee; (3) directing a trustee to refrain from exercising a power or granting a power to a trustee; (4) resignation, appointment, or determination of compensation of a trustee; (5) transferring the principal place of administration of a trust or changing the law governing a trust; (6) determining the liability of a trustee for an action relating to the trust, and (7) establishing criteria for distribution to a beneficiary where the trustee has discretion. All such actions allow the parties to adjust an outdated trust, without the

involvement of the court, to reflect current circumstances. All four of these statutes allow any qualified beneficiary or trustee (Tennessee and Mississippi) or any interested persons (Alabama and Kentucky) to request court approval of the nonjudicial settlement agreement, and such court approval may be for the purpose of determining that "representation" as provided by all four statutes is adequate.

The ability to interpret and agree upon the proper construction of an ambiguous provision in a trust instrument may have significant tax implications if the same resolves issues such as the deductibility of distributions or inclusion of assets in a beneficiary's estate; however, if the goal of a nonjudicial settlement agreement is to interpret or construe the trust to avoid a negative tax determination as the result of an ambiguity in the document, it would be prudent for the parties to request court approval of the agreement. (See *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967); *Ahmanson Foundation v. United States* 674 F.2d 761 (9th Cir. 1981); Revenue Ruling 73-142.) Note, if obtaining court approval, the ambiguity requiring interpretation or construction should be genuine (rather than fictional) in nature to avoid having a court reject the nonjudicial settlement agreement as one that contains terms or conditions that the court could not approve. (See *Hubble Trust v. Commissioner*, T.C. Summ. Op. 2016-67.)

(b) Modification by Consent During Grantor's Lifetime

(T.C.A. §35-15-411(a)) – During the settlor's lifetime, a noncharitable irrevocable trust may be modified by the trustee upon consent of all qualified beneficiaries, even if the modification is inconsistent with a material purpose of the trust, if the settlor does not object to the proposed modification. Mississippi's Uniform Trust Code §91-8-411(a) and Kentucky's Uniform Trust Code §386B.4-110 mirror Tennessee's provision, allowing modification of a noncharitable trust without court order, if the settlor and beneficiaries (Mississippi like Tennessee uses the term "qualified beneficiaries") agree. Alabama's Uniform Trust Code requires court approval of such modification (Ala. Code 1975 §19-3B-411), but all Codes allow for the modification to be inconsistent with a material purpose of the trust if the settlor consents. Copies of the relevant statutes for Tennessee, Mississippi, Alabama and Kentucky are attached as **Exhibit D**.

Tennessee and Mississippi require the trustee to notify the settlor of the proposed modification not less than sixty (60) days before initiating the modification, and the modification must provide an explanation of the reasons for the proposed modification, the date on which the proposed modification is anticipated to occur, and the date, not less than sixty (60) days after the giving of the notice, by which the settlor must notify the trustee of any objection to the proposed modification.

Alabama's and Kentucky's statutes specifically provide that a representative may exercise a settlor's power to consent to a trust's modification as follows: (i) by an agent under a power of attorney only to the extent expressly authorized by the power of attorney and not prohibited by the terms of the trust; (ii) by the settlor's conservator with the approval of the court supervising the conservatorship if an agent is not so authorized and the conservator is not prohibited from doing so by the terms of the trust; or (iii) by the settlor's guardian with the approval of the court supervising the guardianship if an agent is not so authorized, a conservator has not been appointed, and the guardian is not prohibited by the terms of the trust from taking such action. (KRS §386B.4-110.) The Tennessee Uniform Trust Code allows for such representation under §35-15-303 and §35-15-602; however, such power to act on behalf of the settlor must be expressly authorized by the terms of the trust and/or power of attorney.

If the settlor does not object and all the beneficiaries agree (for Tennessee and Mississippi all the qualified beneficiaries must agree), significant modifications can be made to an irrevocable trust to adjust it for changes in the law and/or changes in circumstances. If, however, a qualified beneficiary does not agree, such modifications under T.C.A. §35-15-411(a) can still occur with court approval, if the court is satisfied that (i) if all of the qualified beneficiaries had consented, the trust could have been modified, and (ii) the interests of a qualified beneficiary who does not consent will be adequately protected. This is true under Miss. Code Ann. §91-8-411(d), as well as under KRS §386B.4-110(5), which uses the term "beneficiaries" rather than "qualified beneficiaries." Similarly, upon approval of the court, a modification may still be permissible if the settlor objects to the proposed revision; however, in this case, the modification may not be inconsistent with a material purpose of the trust.

(c) Modification of Uneconomical Trust

(T.C.A. §35-15-414) – After notice to the qualified beneficiaries, the trustee of a trust consisting of trust property having a total value less than one hundred thousand dollars ($100,000) may terminate the trust if the trustee concludes that the value of the trust property is insufficient to justify the cost of the administration. Each of Alabama, Mississippi and Kentucky also allows the trustee of a trust to terminate an uneconomical trust after giving notice to the qualified beneficiaries, and all four states use the term "qualified beneficiaries." Alabama, however, defines uneconomical as "a trust consisting of trust property having a total value less than $50,000" (Ala. Code 1975 §19-3B-414), and Mississippi defines uneconomical as "a trust consisting of trust property having a total value less than One Hundred Fifty Thousand Dollars ($150,000)." (Miss. Code Ann. §91-8-414.)

Kentucky's statute goes beyond the statutes of the other three states, all of which only refer to the trustee of a trust being able to act thereunder; Kentucky's statute extends such right to act beyond the trustee, to include "a personal representative holding or controlling an amount directed by will to be held in trust, . . ." (KRS §386B.4-140.) Such language is useful when a testator dies leaving a will that directs assets to be held in trust for a beneficiary, and the assets have dwindled significantly since the testator prepared his will and/or the beneficiary no longer needs a trust. The personal representative, following the statute, may be able to avoid the trust all together and distribute the bequest to the beneficiary outright. However, the same result can be achieved in Tennessee, and presumably in Alabama and Mississippi, but it requires the involvement of the trustee, who may be a different person/entity than the personal representative.

All four states allow the court to modify or terminate a trust or remove the trustee and appoint a different trustee if it determines that the value of the trust property is insufficient to justify the cost of administration, and being able to remove the trustee and appoint a different trustee may be beneficial where there are reasons that outweigh costs to keep a small trust, but removing a corporate trustee and appointing an individual trustee would at least mitigate the cost of administering the trust. Copies of the relevant statutes for Tennessee, Mississippi, Alabama and Kentucky are attached as **Exhibit E**.

Tennessee and Mississippi require the trustee, when distributing the trust property under this statute, to take into account the interests of income and remainder beneficiaries so as to conform as nearly as possible to the intention of the settlor, but for a trust that qualified for the marital deduction for tax purposes, the trust property must be distributed to the spouse of the settlor for whom the trust was created. (T.C.A. §35-15-414(c) and Miss. Code Ann. $91-8-414(c).) Alabama and Kentucky allow the trustee to distribute the property that would have been held in trust in a manner consistent with the purposes of the trust. (Ala Code 1975 §19-3B-414(c) and KRS §386B.4-140(3).) In making such determination, it is wise to review the document creating the trust, as there may be a provision regarding small trusts that directs where the trust property should go upon a termination, or there may be language indicating that the interests of current beneficiaries are paramount to those of remainder or more remote beneficiaries. Furthermore, Tennessee's and Alabama's commentary on their statutes clearly provide that the amount stated in the statute is a default rule, and a settlor is free to set a higher or lower figure or to specify different procedures. Moreover, the settlor may make it clear in the document that no termination may occur without court order.

(d) Merger and Division of Trusts

(T.C.A. §35-15-417) – Although most documents creating a trust grant the trustee the power to combine two or more trusts or divide a trust into multiply trusts, Tennessee, Alabama, Kentucky and Mississippi specifically give a trustee, after providing notice to the qualified beneficiaries, the authority to combine two (2) or more trusts into a single trust or divide a trust into two (2) or more separate trusts, if the result does not impair rights of any beneficiary or adversely affect the achievement of the purposes of the trust. (T.C.A. §35-15-417, KRS §386B.4-170, Ala. Code 1975 §19-3B-417, and Miss. Code Ann. §91-8-417.) Copies of these statues are attached as **Exhibit F**.

Mississippi's statute provides significant guidance to the trustee and practitioner regarding the use of this authority to combine or divide trusts, and this may be particularly useful when dividing a trust into two (2) or more separate trusts "to reflect a disclaimer, to reflect or result in differences in federal tax attributes, to satisfy any federal tax requirement, to make federal tax elections, to reduce potential generation-skipping transfer tax liability, or for any

other tax- planning purposes or other reasons." (Miss. Code Ann. §91-8-417(b).) Subsections (b) and (c) of the Mississippi statute give clarity and flexibility when using this statute to achieve certain tax results, and subsection (d) provides guidance regarding what is meant by "impairing the rights of a beneficiary."

Subsections (e) and (i) protect the trustee acting under Miss. Code Ann. §91-8-417 from liability, when acting in good faith, and clarify that the power granted under the statute does not give the trustee a general power of appointment over any trust not otherwise expressly granted in the trust instrument.

Tennessee's and Mississippi's statutes both address what happens if the trusts to be combined or divided have different trustees; the statutes give the trustees the right to negotiate the terms of the combined or divided trusts, including which trust or trusts will be the surviving trust or trusts, who will be the trustee or trustees of the surviving trust or trusts, and any other matter relating to the operation of the surviving trust or trusts. (T.C.A. §35-15-417 and Miss. Code Ann. §91-8-417(a).)

Interestingly, these statutes only require the trustee to provide notice to the qualified beneficiaries; they do not require the beneficiaries to give their consent. However, T.C.A. §35-15-410(b) provides that a trustee or beneficiary may seek court approval or disapproval of a trust combination or division under §35-15-417; this may mean that the more the dispositive provisions of the trusts to be combined differ from each other, or the more the terms of the divided trusts diverge from the original trust, the more likely it is that a combination or division would impair some beneficiary's interest or adversely affect the achievement of the settlor's purpose, resulting in legitimate objections to the trustee's action.

(e) Decanting of Trust Property to Another Trust

(T.C.A. §35-15-816(b)(27)) - Unless the terms of the trust instrument expressly provide otherwise, twenty-eight (28) states authorize by statute a trustee's power to make discretionary distributions of trust income and/or principal to a trustee of another trust. Alabama's decanting statute appears to be the newest, becoming effective as of January 1, 2019, and as of

August 20, 2018, Mississippi does not have a decanting statute nor has such a statute been proposed. (See "State Decanting Statutes Passed Or Proposed," compiled by M. Patricia Culler of Hahn Loeser & Parks LLP, Cleveland, Ohio.) Since "a state's decanting statute must be construed in the context of the state's other trust laws[,]" ("Summaries Of State Decanting Statutes," as of August 22, 2014, compiled by Susan T. Bart of Schiff Hardin LLP, Chicago, Illinois), and this presentation is limited in nature, discussion on decanting will focus on Tennessee's decanting statute. Copies of the relevant statutes for Tennessee are attached as **Exhibit G.**

Where the trustee has the authority under the trust instrument to invade the principal of a trust to make distributions to, or for the benefit of, one or more proper objects of the exercise of the power, the trustee may instead exercise such authority by appointing all or part of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created or under the same instrument. (T.C.A. §35-15-816(b)(27)(A).) Such authority does not require court order and it does not require the consent of the beneficiaries, nor does it require notice to the beneficiaries; however, unless the trust instrument provides otherwise, or unless directed by a trust protector or one having the power to direct the trustee under T.C.A. §35-15-808, the trustee may have a duty to inform the beneficiaries under T.C.A. §35-15-813.

The exercise of such authority by a trustee shall not reduce any fixed income interest of any income beneficiary of the trust and must be in favor of the proper objects of the exercise of the power; "[t]his means that new beneficiaries cannot be added to the second trust [new trust], though the second trust does not have to benefit all of the beneficiaries of the original trust." (2013 Restated Comments To Official Text of T.C.A. §35-15-816(b)(27).) The exercise of the power to invade principal of the trust shall not extend the permissible period of the rule against perpetuities that applies to the trust. (T.C.A. §35-15-816(b)(27)(A)(i)(ii) and (C).) Moreover, subsections (G) and (H) provide savings provisions protecting against the loss of tax benefits and qualification of the trust as an S corporation shareholder, if such tax benefits were elected or achieved under the originating trust. The statute provides in subsection (E) that the exercise of the power to appoint principal shall be treated as a limited power of appointment, thereby protecting the trustee from I.R.C. §2041.

The second trust or the new trust may confer a power of appointment upon a beneficiary of the original trust to whom or for the benefit of whom the trustee has the power to distribute principal of the original trust, and the permissible appointees of the power of appointment conferred upon a beneficiary may include persons who are not beneficiaries of the original or second trust. (T.C.A. §35-15-816(b)(27)(F).) This means that a trustee may decant from an irrevocable trust established for the surviving spouse, which does not grant the surviving spouse a limited power of appointment, to a second irrevocable trust for the surviving spouse that does grant to the surviving spouse a limited power of appointment, thereby allowing the surviving spouse to exercise such power to alter the final distribution of the trust property. This would be helpful, for example, in situations where the ultimate beneficiaries receive their inheritance outright and one such beneficiary is receiving government benefits and would, therefore, benefit from a special needs trust.

Decanting is an option where the trustee is unable to modify or merge, because of restrictive language in the trust instrument or the inability to locate all qualified beneficiaries, and there is no trust protector to modify the trust terms. The trustee by decanting to a new or second trust may be able to minimize tax effects on the trust, modify dispositive provisions to eliminate mandatory principal distributions (thereby offering protection to a beneficiary from creditors and/or a dissolving marriage), and as noted above, the trustee by decanting to a second trust which grants powers of appointment to the beneficiaries may alter the final distribution of trust property in a manner that better reflects current laws and circumstances for remainder beneficiaries. To exercise the power to decant, the trustee is required to sign a written, notarized instrument that should be maintained with the records of the original trust as well as the second trust.

(f) Selling Trust Property to Another Trust

(T.C.A. §35-15-816(b)(2)) – All four states provide in their "Specific powers of trustee" that a trustee may "[a]quire or sell property, for cash or on credit, at public or private sale." (T.C.A. §35-15-816(b)(2), Miss. Code Ann. §91-8-816(b)(2), Ala. Code 1975 §19-3B-816(a)(2), and KRS §386B.8-160(2).) Copies of the relevant statutes are attached hereto as

Exhibit H. Such power is subject to the terms of the trust instrument, which may expressly address the trustee's power to sell trust property, as well as to the general powers-of-trustee statutes, which subject the exercise of any power of the trustee to the trustee's fiduciary duties.

Such power to sell may allow the trustee to sell the trust property to another trust, containing new terms that better reflect current circumstances. For instance, if a settlor created an irrevocable life insurance trust to hold a life insurance policy decades ago, and the terms of the old trust are no longer appropriate, in light of changed circumstances, but the terms of the trust and/or the inability to obtain all of the qualified beneficiaries' consent prevents the trustee from decanting, merging or using T.C.A. §35-15-411(a) relating to modification during the settlor's lifetime, then the trustee of the old trust may sell the life insurance policy to the new trust for the policy's fair market value (usually, its interpolated terminal reserve value plus unearned premiums). Following the sale, the old life insurance trust owns a promissory note or cash that is worth substantially less than the death benefit that will be realized from the insurance policy upon the insured's death. This means the large death benefit will be managed and distributed in accordance with the terms of the new trust and a much smaller asset will be disposed of in accordance with the terms of the old trust. ("Sell It For 'Free' – IRS Continues To Approve Life Insurance Sales Between Trusts" by Jon Grob of McGrath North Mullin & Kratz, PC.)

This technique obviously may not be the best solution for policies that have significant surrender value, but for irrevocable life insurance trusts that own term policies, this technique may be a great option, especially when one of the other options will not work. Caution must be taken when selling a life insurance policy to avoid the transfer-for-value rule. The transfer-for-value rule stipulates that, if a life insurance policy is transferred for something of value, a portion of the death benefit is subject to be taxed as ordinary income. This portion is equal to the death benefit minus the item(s) of value, as well as any premiums paid by the transferee at the time of the transfer. If the transfer of the insurance policy is to the insured, such a transfer is exempt from the transfer-for-value rule; therefore, if the buying trust is a "grantor trust" for income tax purposes (i.e., the insured who creates the trust is treated as the owner of the trust for income tax purposes), the sale will not be considered a transfer for value. ("Sell It For 'Free' – IRS

Continues To Approve Life Insurance Sales Between Trusts" by Jon Grob of McGrath North Mullin & Kratz, PC.)

2. Judicial Methods for Modification.

(a) Modification of Trust by Consent

(T.C.A. §35-15-411(b)) – Following a settlor's death, a noncharitable irrevocable trust may be terminated or modified upon consent of all of the qualified beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust or it the court concludes that modification is not inconsistent with a material purpose of the trust. Mississippi has a nearly identical statute to Tennessee's. (Miss. Code Ann. §91-8-411(b).) Alabama and Kentucky, however, do not limit the use of this method to after the settlor's death, and both states require the consent of "all of the beneficiaries," not just the qualified beneficiaries. (Ala. Code 1975 §19-3B-411(b) and KRS §386B.4-110(2).) Copies of the relevant statutes are attached as **Exhibit I**.

Once the settlor passes away, if another nonjudicial method cannot be used (or unless a court order is necessary or preferred), the trustee with the consent of the qualified beneficiaries may petition the court to modify a noncharitable trust, but the modification must not be inconsistent with a material purpose of the trust. Kentucky's statute clearly states that "a spendthrift provision in the terms of the trust is not presumed to constitute a material purposes of the trust." (KRS §386B.4-110(3).) Alabama, however, applies such statement "only to irrevocable trusts created on or after January 1, 2007, and to revocable trusts which become irrevocable on or after January 1, 2007." (Ala. Code 1975 §19-3B-411(c).) Tennessee's and Mississippi's statutes are silent regarding the status of a spendthrift provision; however, Tennessee's comments to §35-15-103(30) give great insight as to why such language was excluded from the statute. See §35-15-105, which provides:

"'Any purpose enunciated as a material purpose of a trust in that trust's trust instrument shall be treated as a material purpose of that trust for all purposes of this chapter and chapter 16.' As stated in the comments to T.C.A. §35-15-105, such results in a settlor also having

the power to so enumerate that a purpose of a trust is not a material purpose of a trust for all purposes of this chapter and chapter 16. Therefore, a settlor can, with greater certainty through drafting, control understanding of that settlor's intent as to what is or is not a material purpose as to any purpose of a trust, including that of a spendthrift provision."

(See 2013 Restated Comments To Official Text of T.C.A. §35-15-103; see also, *In the Matter of Frei Irrevocable Trust Dated October 29, 1996*, 133 Nev. 8 (2017).) This means, as is true when considering any technique of modifying an irrevocable trust, that a thorough review of the trust document must be made to determine if the settlor has specifically enunciated in the document that there is a material purpose for a particular provision. If this is the case, another method for altering the trust should be considered.

T.C.A. §35-15-411(b) may be used to alter an irrevocable trust even if all of the qualified beneficiaries do not consent to the proposed modification; however, before approving the same, the court must be satisfied that (i) if all the qualified beneficiaries had consented, the trust could have been modified under the section, and (ii) the interest of a qualified beneficiary who does not consent will be adequately protected. (See also, Ala. Code 1975 §19-3B-411(e), Miss. Code Ann. §91-8-411(d), and KRS §386B.4-110(5).) Use of this particular statute is limited to noncharitable irrevocable trusts.

(b) <u>Modification of Trust for Unanticipated Circumstances or Inability to Administer Effectively</u>

(T.C.A. §35-15-412) – The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. (See also, Ala. Code 1975 §19-3B-412(a), KRS §386B.4-120(1) and Miss. Code Ann. §91-8-412(a).) Copies of the relevant statutes are attached hereto as **Exhibit J**.

When exercising its equitable powers under this statute, a court should deviate in a manner that follows as nearly as possible the settlor's intent and purposes. (2013 Restated Comments To Official Text of T.C.A. §35-15-412.) An example of modification under

this statute may be to increase the support provision for a trust beneficiary, when such beneficiary has extreme financial hardship due to circumstances outside of his or her control; expanding the beneficiary's support under such unanticipated circumstances would presumably not deviate from the settlor's intent to care for and support the beneficiary.

A second part of this statute provides that the court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration. (T.C.A. §35-15-412(b), Ala. Code 1975 §19-3B-412(b), KRS §386B.4-120(2), and Miss. Code Ann. §91-8-412(b).) If, for instance, an irrevocable trust requires a corporate trustee to serve and due to the value of the trust property (which exceeds the uneconomical trust statute but is less than what a corporate trustee will accept under its management), it has become impracticable to continue trust management by a corporate trustee, the court may modify the trust under this section to remove the requirement that a corporate trustee must serve. The comments to both Tennessee's and Alabama's statutes indicate that subsection (b) may be used to modify a trust where a trust by its terms no longer benefits its beneficiaries; for instance, where a trust is created under a trust instrument for the beneficiaries' education, and all of the beneficiaries of the trust have long since completed their education.

(c) Cy Pres

(T.C.A. §35-15-413) - Under T.C.A. §35-15-410(b), a trustee, beneficiary or settlor of a charitable trust may commence a proceeding to modify or terminate a charitable trust under §35-15- 413, if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, obsolete or ineffective. (See also, Ala. Code 1975 §19-3B-413(a), KRS §386B.4-130(1), and Miss. Code Ann. §91-8-413(a).) In such case, the trust does not fail, in whole or in part; the trust property does not revert to the settlor or the settlor's successors in interest; and the court may apply cy pres to modify or terminate the trust by directing that the trust property be applied or distributed, in whole or in part, in a manner that fulfills as nearly as possible the settlor's charitable intent and purposes. Tennessee's and Mississippi's statutes use the stronger wording "that fulfills as nearly as possible the settlor's charitable intent and purposes," over Alabama's and Kentucky's wording ("in a manner consistent with the settlor's charitable purposes").

However, if the charitable trust provides that such trust property must be distributed to a noncharitable beneficiary where a particular charitable purpose fails, such provision prevails over the power of the court to apply cy pres to modify or terminate the trust, but only if, when the provision takes effect: (i) the trust property is to revert to the settlor and the settlor is still alive, or (ii) fewer than twenty-one (21) years have elapsed since the date of the trust's creation. (T.C.A. §35-15-413(b), Ala. Code 1975 §19-3B-413(b), KRS §386B.4-130(2) and Miss. Code Ann. §91-8-413(b).) Copies of the relevant statutes are attached as **Exhibit K**.

Unlike other sections of the Tennessee Uniform Trust Code which do not grant the settlor standing to commence an action to modify or terminate a noncharitable trust, T.C.A. §35-15-410(b) gives the settlor standing to petition the court to apply cy pres to modify the settlor's charitable trust under T.C.A. §35-15-413, but such authority does not negate the right of the state attorney general to maintain an action on behalf of the charitable trust. Additionally, if the trust document provides, a trust advisor or trust protector may maintain such an action. (2013 Restated Comments To Official Text of T.C.A. §35-15-405.)

(d) Modification to Correct Mistake or to Achieve Settlor's Tax Objective

(T.C.A. 35-15-415) or (T.C.A. §35-15-416) – The first of these statutes allows the court to reform the terms of a trust, even if such terms are unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement. (T.C.A. §35-15-415, KRS §386B.4-150, Ala. Code 1975 §19-3B-415, and Miss. Code Ann. §91-8-415.) Copies of the relevant statutes are attached as **Exhibit L**.

According to the 2013 Comments to Official Text of T.C.A. §35-15-415, "a mistake of expression occurs when the terms of the trust misstate the settlor's intention, fail to include a term that was intended to be included, or include a term that was not intended to be included." Such mistakes are often caused by scriveners' errors. On the other hand, where a trust document accurately reflects what the settlor intended, but the settlor's intentions were based on a mistake of fact or law, then there is a mistake in the inducement. (2013 Restated Comments To Official Text of T.C.A. §35-15-415.)

Because reformation may result in the addition of language or the deletion of language to an otherwise unambiguous trust, extrinsic evidence regarding the settlor's intention may be considered, and to protect against unreliable or contrived evidence in such circumstances, the statute requires clear and convincing proof.

The court may also modify the terms of a trust to achieve the settlor's tax objectives. (T.C.A 35-15-416, Ala. Code 1975 §19-3B-416, KRS §386B.4-160, and Miss. Code Ann. §91-8-416.) Copies of the relevant statutes are attached as **Exhibit M**. The modification may not be contrary to the settlor's probable intention; therefore, as noted in other areas of the Tennessee Uniform Trust Code, the modification must be made "in a manner that fulfills as nearly as possible the settlor's intent and purposes. . . ." (2013 Restated Comments To Official Text of T.C.A. §35-15-416.) As will be discussed below, federal law dictates whether or not a modification made by the court will be recognized under federal tax law, although the statute does state that the court may provide that the modification has retroactive effect. Timing of the modification is crucial according to Revenue Ruling 73-142, which provided that the IRS was bound by the final court order, as such order was "obtained prior to the event that would otherwise have been a taxable event." ("Heckerling Musings 2018 and Estate Planning Current Developments" by Akers, Steve R., Senior Fiduciary Counsel of Bessemer Trust, April 2018, p. 129.)

C. Recent Cases of Interest.

1. Decant? No, you can't!

Hodges v. Johnson, 177 A.3d 86 (N.H. 2017). A copy of this opinion is attached as **Exhibit N**.

David Hodges, Sr. ("David Sr.") founded Hodges Development Company ("HDC") in 1969, which became a successful business venture. As part of his estate planning in 2004, David

Sr. transferred 98% of HDC, which was comprised of nonvoting shares, to an irrevocable GST exempt trust and an irrevocable GST nonexempt trust. David Sr. retained the remaining 2% of the stock, which consisted of the voting shares. Interestingly enough, the 2004 trusts were created through decanting, but the 2004 decanting was not challenged.

The individual beneficiaries of the 2004 trusts were David Sr.'s wife, his three biological children, his two stepchildren, and their descendants. Joanne was David Sr.'s wife, although they divorced during the course of this extended matter. David Sr.'s biological children are David Jr., Nancy and Janice. David's stepchildren are Barry and Patricia. During David Sr.'s lifetime, the beneficiaries had the right of withdrawal upon contributions to the 2004 trusts. Additionally, discretionary distributions could be made by the trustee.

In addition to the individual beneficiaries, the 2004 trusts also allowed distributions to "distributee trusts" which were defined as:

> …any trust being administered…for the benefit of any one or more, but not necessarily all, of the group consisting of [Joanne] and [the settlor's] descendants, or any trust established by [the settlor] under another trust instrument for the benefit of any one or more, but not necessarily all, of the members of such group.

Despite the success of HDC, there was a level of discord with certain family members that increased over time, and the dissonance had an impact on David Sr. personally and on his business. As a result of the discord, David Sr. met with an attorney, JM. JM advised David Sr. that he could remove certain beneficiaries through decanting. JM contacted the trustees, AJ and WS, to discuss decanting with them. The plan called for AJ to resign as trustee and be replaced by JM, after which WS would delegate the decanting power to JM, who would then execute the decanting power. Thereafter, JM would resign, and AJ would resume the role as trustee.

The first (post 2004) decanting was accomplished in 2010. The 2010 decanting created two new trusts with Barry and Patricia removed as beneficiaries.

In 2012, the same decanting process occurred through which David Jr. was removed from the definition of "descendants" in the trust instrument (i.e., David Jr. was removed as a beneficiary).

Finally, in 2013, the decanting process was repeated once again to create two new trusts through which Joanne was removed as a beneficiary.

David Jr., Barry and Patricia joined as plaintiffs and filed an action to declare the decantings void ab initio, and to remove AJ and WS as trustees. Although Joanne was removed as a beneficiary, she did not join as a plaintiff. The defendants asserted that decanting was necessary for the preservation of business operations, and that the trust instruments authorized decanting. However, the trail court ruled for the plaintiffs, and found that the "deeply personal and harsh nature of the decantings" along with the testimony of JM indicated that the decantings were "undertaken and completed at the request, with the blessing, and at the direction" of David Sr.

The New Hampshire Supreme Court affirmed the trial court's ruling that the decanting's were void ad initio because JM, as the decanting trustee, and AJ and WS, to the extent they assisted in facilitating the decantings, failed to give any consideration to the plaintiffs' beneficial interest, and as such, violated the statutory duty of impartiality. The New Hampshire Supreme Court also affirmed the removal of AJ and WS as trustees.

In the final paragraph of the majority opinion, the New Hampshire Supreme Court stated that it would "…leave for another day the issue of whether the defendants are entitled to indemnification for the fees and expenses incurred in this proceeding." This final thought in the opinion was likely a bit unsettling to the trustees.

There was a dissenting opinion in *Hodges*. The dissent was based on the fact that the New Hampshire Supreme Court affirmed the trial court on an alternate ground that was not briefed, and the dissenting judge thought it was improper to decide an important issue of first impression without the benefit of supplemental briefs.

Additionally, the dissenting opinion noted that "…the majority undermines the goal of the [New Hampshire] legislature when it revamped the trust and fiduciary laws to make New Hampshire 'the best and most attractive legal environment in the nation for trust and fiduciary services.'" The dissent continued by stating that the *Hodges* decision does "precisely the opposite" of the legislative intent (that is, "…it makes New Hampshire a less attractive environment for Settlors.").

As a final point, the New Hampshire Trust Counsel[2] filed an amicus curiae brief through which it offered guidance as to why the trial court should be reversed. A copy of the amicus brief is attached as **Exhibit O**.

2. Decant? I don't see why we shan't!

Ferri v. Powell-Ferri, 72 N.E.3d 541 (Mass. 2017). A copy of this opinion is attached as **Exhibit P**.

The *Ferri* case began as a divorce action in Connecticut. The Supreme Court of Connecticut certified the matter to ask three questions of the Supreme Judicial Court of Massachusetts pertaining to the use of decanting.

Paul J. Ferri created a trust for the sole benefit of his son, Paul John Ferri, Jr. in 1983 (the "1983 Trust"). The 1983 Trust was created in Massachusetts and was governed by Massachusetts law. The 1983 Trust allowed Paul Jr. to request withdrawals of principal up to 25% at 35 years of age, and up to 100% at the age of 47. The 1983 Trust also allowed the trustee to "pay or to segregate irrevocably" trust assets for the beneficiary (i.e., Paul Jr.).

[2] As stated in the brief, the New Hampshire Trust Council is a New Hampshire nonprofit corporation based in Hampton, New Hampshire. The Trust Council's members include trust companies, law firms, and other persons who believe the Trust Council's mission of promoting the trust services sector in New Hampshire. Since its formation in 2010, the Trust Council has been actively involved in proposing and supporting legislation to modernize and enhance New Hampshire's laws governing trusts, trust companies, and family trust companies.

Paul Jr. and Nancy Powell-Ferri married in 1995. In 2010 Ms. Powell-Ferri filed for divorce in Connecticut.

In 2011 the trustees of the 1983 Trust created the Declaration of Trust for Paul John Ferri, Jr. (the "2011 Trust), and distributed substantially all of the assets from the 1983 Trust to the 2011 Trust. The trustees did this without informing Paul Jr. and without his consent. The trustees decanted the 1983 Trust out of concern that Ms. Powell-Ferri would reach the assets of the 1983 Trust.

The Connecticut Supreme Court certified the matter to the Massachusetts Court and asked the following three questions:

> "1. Under Massachusetts law, did the terms of the Paul John Ferri, Jr. Trust (1983 Trust) empower its trustees to distribute substantially all of its assets (that is, to decant) to the Declaration of Trust for Paul John Ferri, Jr. (2011 Trust)?
>
> 2. If the answer to question 1 is 'no,' should either 75% or 100% of the assets of the 2011 Trust be returned to the 1983 Trust to restore the status quo prior to the decanting?
>
> 3. Under Massachusetts law, should a court, in interpreting whether the 1983 Trust's settlor intended to permit decanting to another trust, consider an affidavit of the settlor ..., offered to establish what he intended when he created the 1983 Trust?"[3]

[3] The opinion included the following language with respect to the affidavit:

> "The settlor's affidavit, dated July 11, 2012, states, in pertinent part:
>
> > 'I intended to give to the trustee of the 1983 Trust the specific authority to do whatever he or she believed to be necessary and in the best interest of my son Paul John Ferri, Jr. with respect to the income and principal of the 1983 Trust notwithstanding any of the other provisions of the 1983 Trust.... Therefore, if the trustee thought at any time that the principal and income of the 1983 Trust could be at risk, the trustee could take any action necessary to protect the principal and income of the 1983 Trust.... This authority to protect assets would also extend to a situation where creditors of

The Massachusetts Court answered question 1 and question 3 in the affirmative (which made answering the second question unnecessary).[4] Accordingly, the decanting of the 1983 Trust was deemed proper.

A concurring opinion accompanied the *Ferri* decision to emphasize that the Massachusetts Supreme Judicial Court "…did not decide in answering the reported questions certified…by the Connecticut Supreme Court: whether Massachusetts law will permit trustees in Massachusetts to create a new spendthrift trust and decant to it all the assets from an existing nonspendthrift trust where the sole purpose of the transfer is to remove the trust's assets from the marital assets that might be distributed to the beneficiary's spouse in a divorce action."

The concurring opinion went on to state that the "…Connecticut Supreme Court held that, under Connecticut law, the public policy that would prevent one spouse during a divorce proceeding from transferring marital assets to deprive the other spouse of those assets did not apply here because it was undisputed that the beneficiary husband did not have a role in creating the new 2011 Trust or in decanting the assets from the 1983 Trust to the 2011 Trust." *Ferri v. Powell-Ferri*, 317 Conn. 223 (2015).

Lastly, the concurring opinion added that the "…trial court had found that the trustees of the 1983 Trust, one of whom was the husband's brother, did not consult with the husband before taking these steps to frustrate the wife's equitable claim to these assets. Our opinion, because it simply answered certified questions from another State Supreme Court, appropriately did not address whether we would find the creation of a new spendthrift trust intended solely to deprive the beneficiary's spouse of marital assets during a divorce proceeding through a decanting to be invalid as contrary to public policy under Massachusetts law."[5]

Paul John Ferri, Jr. may attempt to reach the assets of the 1983 Trust such as in the event of lawsuit or a divorce.'"

[4] In deciding that decanting was appropriate, the Court made reference to *Morse v. Kraft*, 992 N.E.2d 1021 (Mass. 2013).

[5] The majority also acknowledged the potential impact of decanting on the division of assets in footnote 10 to the opinion: "We are cognizant that the Connecticut judge relied heavily in her determination that the decanting was not authorized under the terms of the 1983 Trust based on her understanding of divorce law in Connecticut, and its policies

One final item worth pondering in the *Ferri* decision is that the Massachusetts Supreme Judicial Court noted that there may be a duty to decant if the trustee deems decanting to be in the best interest of a beneficiary.

3. "You were serious about that?" –My Cousin Vinny

Matter of Frei Irrevocable Trust Dated October 29, 1996, 390 P.3d 646 (Nev. 2017). A copy of this opinion is attached as **Exhibit Q**.

Husband and wife, Emil Frei, III and Adoria Frei, created the Frei Irrevocable Trust in 1996 (the "1996 Trust"). Emil had five children prior to his marriage to Adoria, and Adoria likewise had five children before marrying Emil. Each of the ten children were listed as equal beneficiaries of the 1996 Trust.

Adoria died in 2009, and shortly thereafter her son, Stephen Brock, with Emil's consent, petitioned the district court to alter the language governing beneficiary distributions to add the right to compel distributions. In particular, Stephen sought to add the following language:

> "Upon an election in writing by any child of ours delivered to our Trustee, the trust share set aside for such child shall forthwith terminate and our Trustee shall distribute all undistributed net income and principal to such child outright and free of the trust."

Stephen provided notice to all of his siblings and step-siblings. There were no objections to the proposed change, and based on this fact the district court granted the requested modification. Accordingly, Stephen was successful in obtaining the result he sought.

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that all assets of a marriage on the date that an action for dissolution is filed are available for later distribution. We note in this regard, as the trial judge herself apparently already has anticipated by suggesting an alternative order for payment of alimony if the decanting is deemed proper, that the alimony order may be revised in light of this determination as to the trust assets. See *Pfannenstiehl v. Pfannenstiehl*, 475 Mass. 105 (2016).

After the district court approved the modification requested by Stephen, Premier Trust, Inc. became co-trustee of the 1996 Trust.

In 2010, Stephen settled a number of lawsuits brought against him by Emil and his children. The lawsuits alleged mismanagement of a different family trust (the "Other Trust"). It should be noted that Stephen consulted with an attorney before agreeing to settle. Additionally, the trial judge "canvassed" Stephen to ensure that he understood the terms of the settlement before signing the order approving the settlement. While Stephen did not admit wrongdoing, he did agree to pay $415,000 to the Other Trust, and pledged his interest in the 1996 Trust as security. However, Stephen made only one payment in the amount of $5,000.

Emil died in 2013, at which point nine of the beneficiaries requested their respective share of the 1996 Trust. Only Stephen did not request his share.

The trustees of the Other Trust demanded that Premier Trust, Inc. use Stephen's share of the 1996 Trust to pay the funds owed to the Other Trust. Premier Trust, Inc. paid a total of $300,000 in three installments of $100,000. Thereafter, Stephen filed a lawsuit to construe the terms of the 1996 Trust, recover the $300,000, and remove Premier Trust, Inc. as trustee.

While Stephen was successful in petitioning the district court that he should have been allowed to modify the 1996 Trust, Stephen was unsuccessful in arguing before the Supreme Court of Nevada that he should not have been allowed to modify the 1996 Trust. It is acknowledged that the preceding sentence is confusing, and states contrary positions – which is why the Supreme Court affirmed the district court ruling that Stephen was bound by his first position, and that judicial estoppel precluded him from relitigating a previously final matter.

The Supreme Court of Nevada also affirmed the $300,000 payment was proper, and that Premier Trust, Inc. did not breach its fiduciary duty.

D. Tax Implications.

Given the number of options for modifying irrevocable trusts, one would think it would be easy to modify a trust. However, it is not easy. There are many factors to consider, including interested parties (such as beneficiaries with dynamic personalities who are not afraid to sue a trustee) and the taxing authorities. Navigating the various laws governing how trusts are taxed can be daunting. Additionally, there is insufficient guidance with respect to the tax consequences of decanting (and to some extent, regarding other modifications to trusts).

In Rev. Proc. 2011-3, the IRS placed decanting on its "no ruling" list. After issuing Rev. Proc 2011-3, the IRS placed decanting on the 2011-2012 Priority Guidance Plan as item 13 in the "gifts and estates and trusts" section ("Notice on decanting of trusts under §§2501 and 2601."). The IRS issued Notice 2011-101 on December 27, 2011 requesting written comments on decanting be submitted by April 25, 2012. However, decanting was removed from the 2012-2013 Priority Guidance Plan, and has not been listed since. The IRS continues to be consistent in refraining from offering guidance on certain decanting issues, as was seen most recently in Rev. Proc. 2019-3, which contains the following in Section 5:

> Section 5. Areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a Revenue Ruling, a Revenue Procedure, Regulations, or otherwise.
>
> (7) Sections 661 and 662. — Deduction for Estates and Trusts Accumulating Income or Distributing Corpus; Inclusion of Amounts in Gross Income of Beneficiaries of Estates and Trusts Accumulating Income or Distributing Corpus. — Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a distribution for which a deduction is allowable under § 661 or which requires an amount to be included in the gross income of any person under § 662.

(12) Section 2501. — Imposition of Tax. — Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a gift under § 2501.

(13) Sections 2601 and 2663. — Tax Imposed; Regulations. — Whether the distribution of property by a trustee from an irrevocable generation-skipping transfer tax (GST) exempt trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is the loss of GST exempt status or constitutes a taxable termination or taxable distribution under § 2612.

While there is limited guidance regarding the tax impact of decanting, there are a number of tax issues which must be contemplated prior to decanting. Decanting can have an impact on income tax, gift tax, estate tax, generation-skipping tax, and state and local taxes.[6]

1. Income Tax.

Generally speaking, decanting should not have a tax consequence for income tax purposes (assuming the decanting involves domestic trusts and does not make certain changes, such as decanting from a grantor trust to a nongrantor trust). Nonetheless, careful consideration should be given to all aspects of the transfer, as there are various potential esoteric issues that could cause unpleasant tax results, such as when property with debt in excess of basis is decanted.[7]

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[6] Jonathan G. Blattmachr, Jerold I. Horn, & Diana S.C. Zeydel, *An Analysis of the Tax Effects of Decanting*, 47 REAL PROP., TR. & EST. L. J. 141 (2012). This article is a great resource for the various tax issues that can arise when decanting is used.

[7] Farhad Aghdami and Daniel J. Durst, *Decanting Comes of Age*, Washington, D.C. Est. Plan. Council (Feb. 12, 2018), http://www.wdcepc.org/assets/Councils/Washington-DC/library/Decanting%20%28Trusts%29%20Outline%20-%20Feb%202018.pdf. This excellent article provides an in-depth discussion of the various tax issues pertaining to decanting.

2. Gift Tax.

To avoid potential gift tax issues, it is advisable for a trustee who is also a beneficiary not to exercise the discretion to decant. Similarly, a gift tax issue can arise if the ability to decant is dependent on the consent of a beneficiary. While the gift tax implications will have to be assessed for each use of decanting, it is possible to avoid any negative gift tax results.[8]

3. Estate Tax.

Decanting from the original trust to the second trust likely will not trigger estate tax inclusion unless there is a string, such as a general power of appointment in the Second Trust. See I.R.C. § 2041(a)(2). Note that some decanting statutes include language to preserve existing favorable tax treatment. For example, T.C.A. § 35-15-816(b)(27)(G) states the following (which is followed by official comments):

> (G) If any contribution to the original trust qualified for the annual exclusion under § 2503(b) of the Internal Revenue Code (26 U.S.C. § 2503(b)), the marital deduction under §§ 2056(a) or 2523(a) of the Internal Revenue Code (26 U.S.C. §§ 2506(a) or 2523(a)), or the charitable deduction under §§ 170(a), 642(c), 2055(a) or 2522(a) of the Internal Revenue Code (26 U.S.C. §§ 170(a), 642(c), 2055(a) or 2522(a)), is a direct skip qualifying for treatment under § 2642(c) of the Internal Revenue Code (26 U.S.C. § 2642(c)), or qualified for any other specific tax benefit that would be lost by the existence of the authorized trustee's authority under subdivision (b)(27)(A) for income, gift, estate, or generation-skipping transfer tax purposes under the Internal Revenue Code, then the authorized trustee shall not have the power to distribute the principal of a trust pursuant to subdivision (b)(27)(A) in a manner that would prevent the contribution to the original trust from qualifying for or would reduce the exclusion, deduction, or other tax benefit that was originally claimed with respect to that contribution;

From the 2013 Restated Comments:

[8] William R. Culp, Jr. and Briani Bennett Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 45 REAL PROP., TR. & EST. L. J 1 (2010)

There are several limitations on the exercise of the power that prevent loss of tax benefits:

(1) the permissible rule of perpetuities applicable to the original trust may not be extended either by exercise of the decanting power or by the exercise of a power of appointment granted to a beneficiary in the second trust;

(2) if the original trust qualified for the federal gift tax annual exclusion under Code Section 2503(b), the federal gift or estate tax marital or charitable deduction, favorable generation-skipping transfer treatment under Code Section 2642(c), or any other specific tax benefit, the decanting power may not be exercised in a manner that causes the loss of the tax benefit; and

(3) if the original trust owns stock in a Subchapter S corporation, the power may not be exercised in favor of a second trust that is not a qualified shareholder in a Subchapter S corporation.

4. Generation-Skipping Transfer Tax.

The impact of decanting on GST tax should be considered carefully. Among other issues, the trustee must consider the inclusion ratio of the original trust and whether a grandfathered trust is placed at risk by decanting.[9] In accessing the tax risks, attorneys can be creative, such as seeking an order from a court making the proposed transfer contingent upon a favorable ruling from the court (for example, see PLR 201829005).

[9] In response to Notice 2011-101, on April 2, 2012, ACTEC issued comments on the need for additional guidance on the tax effects of decanting, including the impact on GST tax. This work by ACTEC is an indispensable resource on this unsettled topic. Comments of The American College of Trust and Estate Council on Transfer by a Trustee from an Irrevocable Trust to Another Irrevocable Trust (Sometimes called "Decanting")(Notice 2011-101) Release December 21, 2011) can be found at https://www.actec.org/resources/comments-on-transfers-by-a-trustee.

5. State and Local Taxes.

While a lot of attention is given to federal taxes, taxation at the state or local level can also be impacted by decanting or other trust modifications. For example, Tennessee provides favorable tax treatment to land that has a "greenbelt" status; that is, agricultural land, forest land, and open space. T.C.A. § 67-5-1001 et seq. To maintain greenbelt status along with the associated favorable tax treatment, a "new owner" of the land must reapply for the status. If a new owner does not reapply, land that was under the greenbelt with the old owner will lose its status and incur "rollback" taxes. Query whether a decanted trust is a new owner for greenbelt purposes.

It is without question that it is best to reflect contemplatively when considering whether or not to decant and how to implement the process.[10] There are traps waiting that are not always readily apparent. Moreover, while the main focus is usually on income tax, gift tax, estate tax, and GST tax, there are other logistical tax issues to ponder when decanting. For example, a recent discussion on the ACTEC Listserve addressed the topic of decanted trusts, the use of an EIN, and reaffirming prior tax elections. Routine tax concepts can become much more complex when decanting or other trust modification techniques are used.

[10] For a comprehensive and superb discussion of the tax implications of decanting, see Culp & Bennett Mellen, 871 T.M., Trust Decanting (Bloomberg Tax).