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**Care and Feeding of a Dynasty Trust: High Protein or Low Fat?**

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## I. Introduction

The advent of the current version of the generation-skipping transfer tax is at least partially responsible for the increased popularity of long-duration irrevocable trusts.[1] Many states have modified their statutes to accommodate this trend either by eliminating the rule against perpetuities or by substantially increasing the period during which a party may hold property in trust.[2] An increased desire to achieve asset protection[3] through the use of trusts may also be responsible for the increased use of long-duration irrevocable trusts, commonly referred to as "dynasty trusts". Yet drafting a long-term irrevocable trust is a challenging undertaking for the draftsperson. During the continuation of the trust, the law, the financial circumstances of the trust, the circumstances of the trust beneficiaries, or all of those may change in a way that was not foreseen or considered when the governing instrument was drafted. These changes might render the trust's terms more adverse, inefficient, or disadvantageous to the beneficiaries than other terms would be.

The concern about an apparent increase in "dead hand" control over property disposition that has resulted from the trend towards extreme-duration irrevocable trusts has led the American Law Institute to propose amendments not only to the rule against perpetuities, but also to the consequences of a trust that state law permits to continue beyond the period that the rule defines.[4] *Restatement (Third) of Property* adds a judicial modification provision making a trust or other donative disposition of property subject to judicial modification to the extent that the trust or other disposition does not terminate on or before the expiration of the perpetuity period.[5]

The first part of this Article will suggest potential approaches to drafting a long duration dynasty trust for flexibility in the context of tax uncertainty. The second part of this Article will address the possibility and consequences of making changes to an existing trust that may not have anticipated the need or desire to make changes.

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[1] *See* Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 410 (2005).

[2] *See id*. at 110-12.

[3] Asset protection includes the ability to shield assets from the claims of creditors. *See* H. Rosen & G. Rothschild, 810-3rd Tax Mgmt. (BNA) Estates, Gifts, and Trusts; T. Flubacher & R. Herndon, Jr., *Delaware Asset Protection Trusts and Creditors' Rights*, EST. PLAN., Sept. 2010, at 19, 20.

[4] *See* RESTATEMENT (THIRD) OF PROPERTY (WILLS & OTHER DONATIVE TRANSFERS) § 27 (2011). The Restatement would provide an exception such that if, upon the expiration of the perpetuity period, the share of a beneficiary is distributable when the beneficiary reaches a specified age and the beneficiary is then younger than the earlier of the specified age or the age of thirty, the trustee may, without judicial modification, retain the beneficiary's share in trust until the beneficiary reaches thirty years or the specified age, whichever is earlier. *See id*. § 27.1 cmt. b.

[5] *See id*. Concerned about the potential harm of an irrevocable trust with extreme duration, the drafting committee that extended Florida's rule against perpetuities to 360 years added a provision to Florida's version of the Uniform Trust Code that requires a trust taking advantage of the longer term to permit judicial modification of the trust in the interest of the beneficiaries. *See* FLA. STAT. ANN. § 736.04115(3) (West 2010) (providing that its provisions permitting judicial modification of a trust in the best interests of the beneficiaries will not apply to a trust created after December 31, 2000, only if "all beneficial interests in the trust must vest or terminate within the period prescribed by the rule against perpetuities in [section] 689.225(2), notwithstanding [section] 689.225(2)(f)" (in other words, the common law rule) and finding that the trust prohibits judicial modification).

II. Dynasty Trusts.

A. The Basics.

A dynasty trust is a long duration trust that continues for multiple generations until the expiration of the applicable rule against perpetuities. Some jurisdictions permit so-called perpetual trusts, but frequently have a maximum duration such as 360 years or 1,000 years. Dynasty trusts frequently are designed to permit the accumulation of trust income and principal during the settlor's lifetime. Often, a dynasty trust is structured as a so-called grantor trust for federal income tax purposes, which requires the grantor to pay personally the entire federal (and typically state) income taxes on the assets held in the trust, thereby effectively allowing the value of those assets to compound within the trust income tax-free.[6] At the settlor's death, or the death of a surviving spouse, the dynasty trust is frequently divided into per stirpital shares for the settlor's issue, although some settlors prefer for the single or "pot" trust to continue at least during the lives of the settlor's children as a potential mechanism to further delay the payment of wealth transfer (that is, gift, estate and generation-skipping transfer) taxes. Either through the trustee's discretionary power to distribute income and principal or a series of limited powers of appointment held by trust beneficiaries, or some combination of the two, the trust assets are available to be distributed (rather than accumulated) to or for the benefit of the trust beneficiaries at all times. If the beneficiaries have sufficient assets outside the dynasty trust to meet their needs, the assets in the trust will continue to grow for the benefit of future generations of the settlor's issue. Typically, ultimate charitable beneficiaries or intestate heirs are named in the event none of the settlor's issue is living before the dynasty trust is exhausted.

Dynasty trusts provide numerous benefits unavailable if assets are transferred outright to the beneficiaries, including potential state income tax savings, transfer tax savings, and creditor protection.[7] Under the generation-skipping transfer ("GST") tax as in effect in 2017, each person has a $5,490,000 exemption available for use during lifetime or at death which matches the $5,490,000 exemption from the federal gift tax.[8] If GST exemption is allocated to a transfer to a dynasty trust, the trust and all transfers from the trust are exempt from GST tax. If a trust's settlor and the settlor's spouse agree to "split" the gift to the dynasty trust, pursuant to section 2513, both spouses may allocate their GST tax exemptions to a single trust.[9] Thus, a married couple can fund an approximately $11 million dynasty trust that is entirely exempt from gift tax, estate tax and GST tax for so long as the assets are held in trust. Such a trust remains exempt no matter how large the corpus grows.

Frequently, settlors may wish to create a dynasty trust that is taxed as a grantor trust and then sell an asset, such as a closely held business, start-up company, or some other type of growth asset, to the trust in exchange for an installment note. The conventional wisdom with such transactions is that the trust must have assets independent of the assets purchased in order for the transaction to be respected as a sale for debt, rather than a transfer with a retained interest.[10] If a settlor of a trust is able to fund a trust with $11,000,000, the settlor could sell a growth asset valued in excess of $100,000,000 to the trust, and all of the growth on that asset, after repayment of the debt, would be outside of the transfer tax system. This could be a very powerful estate "freeze" technique. Even if the estate and GST taxes are repealed, the gift tax may remain in effect. Therefore, if the settlor wishes to transfer assets to the settlor's issue during lifetime, an estate freeze will continue to provide the opportunity to do so without the current payment of gift tax. Moreover, it probably will protect the assets from estate and GST taxes even if these taxes are reenacted at a later time.

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[6] *See* I.R.C. §§ 671-679 and Rev. Rul. 2004-64 2004-2 CB 7.

[7] *See* T. Pulsifer & T. Flubacher, *Dynasty Trusts May Be Even More Powerful If Transfer Tax Laws Change*, Estate Planning Vol. 34 No. 11 (November 2007).

[8] *See* I.R.C. §§ 2631; 2505. All references to a "section" or "§" of the Code or the Treasury Regulations refer to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

[9] I.R.C. § 2652(a)(2). Note, however, that under section 2513, gift-splitting is unavailable if the settlor's spouse is also a discretionary beneficiary of the trust such that the interest of the spouse cannot be quantified.

[10] *See* M. Gans & J. Blattmachr, *Private Annuities and Installment Sales: Trombetta and Section 2036*, 120 J. TAX'N 227 (May 2014).

Additionally, a dynasty trust is an excellent vehicle for life insurance. Large life insurance policies, including private placement life insurance[11], could be purchased within a dynasty trust and the death benefit (which usually will be received free of income tax pursuant to section 101(a)(1)) may be held in trust for multiple future generations. Life insurance will continue to be viable as an income replacement tool, in the event of the premature death of a provider, even if estate and GST taxes are repealed, and funding a policy without the payment of gift tax for the benefit of multiple generations is optimally done by using a dynasty trust.

Nonresident aliens may also create long duration trusts for the benefit of their issue who are United States citizens, the assets of which would not be subject to the U.S. transfer tax system.

1. <u>Grantor Trusts.</u>

Usually, a dynasty trust will be structured as a so-called grantor trust for federal income tax purposes, meaning that the grantor will pay the income tax on the trust's income and the trust will grow tax free for the rest of the grantor's life.[12] This is generally viewed as an estate planning advantage because the grantor's payment of the trust's income taxes is not treated as an additional taxable gift to the trust; accordingly, the trust receives the benefit of growing free from income taxes for future generations. In Revenue Ruling 2004-64, the IRS made it clear that a settlor's payment of income tax on the income of a grantor trust, the contributions to which were the subject of completed gifts, is not treated as an additional gift to the trust.[13] Typically, the trust is treated as a grantor trust because of the inclusion of a provision that allows the grantor to substitute property for property of an equivalent value.[14] It is generally recommended to include more than one provisions that will cause the trust to be treated as a grantor trust, to ensure the desired income tax treatment.[15] The grantor's non-fiduciary power to acquire trust property by substituting property of equivalent value should not, by itself, cause the value of the trust principal to be included in the grantor's taxable estate under section 2036 or 2038, so long as the trustee has a fiduciary duty, under either the trust instrument or applicable local law, to insure that the substituted properties are in fact of equivalent value, and the exercise of the power does not shift benefits among trust beneficiaries.[16] Making the spouse a discretionary beneficiary of both trust income and principal or giving an independent person the power to add beneficiaries will also cause a trust to be treated as a grantor trust. A flexibly drafted grantor trust should also confer the ability to "turn off" grantor trust treatment by releasing or disclaiming the powers causing grantor trust treatment.[17]

Many states have enacted laws that impose a duty upon the fiduciary responsible for investments to ensure equivalent value so that the trust administration complies with Revenue Ruling 2008-22.[18] A typical state statute would provide that if a trustor has a substitution power, the fiduciary

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[11] See, generally, W. Lipkind & J. Blattmachr, Income Tax Aspects of Variable Life Insurance Policies," 121 J. TAX'N, 52 (Feb 2015).
[12] I.R.C. §§ 671-679.
[13] Rev. Rul. 2004-64, 2004-2 CB 7.
[14] *See* I.R.C. 675(4)(C).
[15] *See* S. Akers, F. Boyle & J.. BLATTMACHR, "Creating Intentional Grantor Trusts," Real Property, Trust and Estate Law Journal, Volume 44, Number 2, (Summer 2009).
[16] *See* Rev. Rul. 2008-22, 2008-1 C.B. 796 (A grantor's non-fiduciary power to acquire trust property by substituting property of equivalent value will not, by itself, cause the value of the trust principal to be included in the grantor's taxable estate under I.R.C. Section 2036 or 2038, so long as the trustee has a fiduciary duty, under either the trust instrument or applicable local law, to insure that the substituted properties are in fact of equivalent value, and the exercise of the power does not shift benefits among trust beneficiaries); *see also* Rev. Rul. 2011-28, 2011-49 I.R.B. 830 (applying the same reasoning to the substitution of a life insurance policy).
[17] Note that there may be fiduciary concerns if this power is given to the trustee because shifting the income tax burden from the grantor to the trust arguably impairs the interests of the beneficiaries, and some commentators have observed that such a decision may be contrary to a fiduciary's duties owed to the beneficiaries.
[18] *See, e.g.*, 12 Del. C. § 3316.

responsible for investment decisions has a fiduciary duty to determine that the substituted property is of equivalent value prior to allowing the substitution.[19]

In Rev. Rul. 2004-64, the IRS ruled that if, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross estate under section 2036(a)(1).[20] If, however, the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the grantor for that portion of the grantor's income tax liability, the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate. However, if applicable local law would subject the trust assets to the claims of the grantor's creditors, then that may cause inclusion of trust's assets in the grantor's gross estate for federal estate tax purposes.[21] Consequently, many states, such as those that have enacted spendthrift statutes, have a statute which provides that a trustee's discretionary authority to pay directly or to reimburse the settlor for any tax on trust income or principal that is payable by the grantor shall not be considered to be an amount that can be distributed to or for the grantor's benefit, and a creditor or assignee of the settlor shall not be entitled to reach any amount solely by reason of this discretionary authority.[22] Thus, the grantor can retain the right to be reimbursed from the trust for income tax liabilities and, so long as this does not cause the trust assets to become subject to the claims of the grantor's creditors, this should not produce adverse estate tax consequences. Note, however, that section 2036(a) also may apply if the IRS can demonstrate an implied understanding that trust income would be used for the benefit of the taxpayer.[23] Accordingly, a pattern of consistent reimbursement of the grantor's income taxes may cause the trust's assets to become included in the transferor's gross estate.

2. Non-GST Exempt Dynasty Trusts.

A transfer to a trust for the benefit of the settlor's issue including children is not subject to the GST tax because such a trust is not a "skip person".[24] Such a trust can be designed, for example, so that no taxable termination occurs until the last of the settlor's children dies.[25] If, prior to the death of the settlor's last surviving child, the trustee makes a taxable distribution from the trust, the distribution is subject to a single GST tax, no matter how many generations are skipped.[26] Thus, by creating a non-exempt dynasty trust and causing a one-time GST tax, it may be possible to transfer assets from the settlor through the trust to issue of the settlor born long after the settlor's death and after the deaths of all but one of the settlor's children with the imposition of only a single GST tax on the assets.

B. What if There's No Estate Tax?

On September 27, 2017, the White House and congressional Republicans issued a nine-page document laying out their tax proposal. The entire text of the Republican plan that addresses estate and generation skipping transfer taxes states: "The framework repeals the death tax and the generation-skipping transfer tax."[27] Notwithstanding estate and GST tax repeal, dynasty trusts drafted to maximize flexibility should continue to be a most desirable estate planning tool, providing adaptability, appropriate governance, creditor protection and state income tax avoidance, all in a transfer-tax free safe-haven. In other words,

[19] *See*, *e.g.* 12 Del. C. § 3316.
[20] Rev. Rul. 2004-64, 2004-2 CB 7.
[21] Rev. Rul. 79-63, 1979-1 C.B. 302.
[22] *See*, *e.g.*, VA Code § 64.2-747; EPTL § 7-3.1; 12 Del. C. § 3536(c).
[23] *See* Reg. § 20.2036-1(c)(1)(a) ("An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express, or implied, that the interest or right would later be conferred.").
[24] I.R.C. § 2613(a)(2)(A).
[25] *See* C. Harrington & F. Acker, 850 T.M. Generation-Skipping Tax at A-18.
[26] *Id*. at 20; Code § 2612(a).
[27] https://waysandmeansforms.house.gov/uploadedfiles/tax_framework.pdf.

every client, big and small, should be packing as many assets as possible into flexible perpetual irrevocable trusts.[28]

There are many unanswered questions regarding what will replace the estate tax if it is repealed. President Trump has proposed some form of capital gains tax at death on assets in excess of $10 million, with some limited exception for farms and family businesses. Another alternative is carry-over basis like that found under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). Regardless of the income tax regime that may be imposed at death, most prognosticators believe that the gift tax will remain in place. The gift tax was retained under EGTRRA on the basis that it is a necessary back-stop to the income tax to prevent wealthy individuals in the highest tax bracket, or with limited off-setting deductions, from avoiding income taxes by transferring their assets to individuals in lower income tax brackets.[29] One might question whether the gift tax is really a necessary backstop to the income tax. It seems that lifetime transfers have always been a difficult hurdle for wealthy clients, even though that taxation of gifts is more favorable than taxation at death. It seems unlikely that a parent would actually hand over his or her wealth to a child with the hopes that the child might return that wealth solely to save income taxes. Many clients do not wish their descendants to know about their wealth, much less receive substantial gifts currently. And there may also be the concern of subjected the gifted assets to creditor claims or to the grasp of in-laws. Gifts in trust have little potential to reduce income taxes because of the compressed rate brackets on non-grantor trusts. However, the ability of a trust to shift its income, under sections 661 and 662, to beneficiaries can provide an opportunity to reduce income taxes.

Perhaps, the real motivation for retaining the gift tax is that Congress anticipates the possible re-enactment of the estate and GST taxes by a future Congress, and by retaining the gift tax, the benefit of repeal would be reserved for the "lucky" few who die while it is repealed. Without a gift tax, many more clients would consider transferring assets to a flexibly drafted, grantor, dynasty trust that could serve as a transfer tax-free safe-haven for family wealth for future generations.

Suppose that following estate tax and GST tax repeal, a wealthy client simply bequeaths all of his or her assets outright to children or grandchildren because there is no longer an estate tax or GST tax limiting such an outright bequest. Now those assets are in the children or grandchildren's hands. An outright bequest does not address the risk that wealth would be dissipated in a single generation due to unprepared spendthrift descendants, untimely deaths, the possible return of the estate tax, creditors' claims and divorce settlements. If an estate or GST tax is ever reinstituted, any assets remaining in the hands of the beneficiaries would be subject to those taxes. Even if the estate and GST taxes are not reinstituted, the gift tax seems likely to remain in place, requiring the beneficiaries to engage in sophisticated estate planning that the creator of the wealth may be in a better position to address, in order for the beneficiaries to confer lifetime benefits on their own descendants. Providing access to the assets to a child or grandchild (other than for tuition or medical expenses) would be limited to lifetime wealth transfer techniques such as loans, annual exclusion gifts or effective use of the gift tax exemption.

Making a taxable gift would be foolish in the world of repeal. If the beneficiaries had instead received the inheritance in a flexible dynasty trust, all future generations could benefit from the wealth without the application of any gift tax through discretionary distributions by the trustee, and provide for future generations by means of the exercise of powers of appointment. A dynasty trust could sprinkle distributions among generations of the client's descendants, enable the use and enjoyment of trust property and adapt to future changes to the family situation and tax laws, while providing creditor protection and allowing the beneficiaries to enjoy substantial control over the trust.

Dynasty trusts help families with any level of wealth protect their assets from creditors, avoid or minimize state income taxes, avoid or minimize gift taxes and handle any future Congressional change of heart regarding the estate and GST tax law while serving as a powerful tool for making intergenerational transfers of wealth. A dynasty trust agreement can be designed to provide beneficiaries with enormous benefits beyond the traditional right to receive outright distributions.

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[28] *See* T. Flubacher, *How to Deal With Repeal - Dynasty Trust Planning Will Be an Essential Tool*, Trusts & Estates Magazine (March 2017).
[29] *See* 65 Cong. Rec. 3120, 3172-93 (1924); *see generally* R. Magill, *The Federal Gift Tax*, 40 COL. L. REV. 773 (1940).

Many descendants' initial reaction may be to prefer an outright distribution of wealth rather than a beneficial interest in a trust because of a perception that trusts are a costly and burdensome tool of the lawyers and bankers that removes control of the family wealth to third parties who then determine rights to the use and enjoyment of the assets. However, heirs should prefer receiving an inheritance in the form of a well-designed dynasty trust rather than an outright bequest, if their goal is continued enjoyment of the assets with a substantially reduced risk of diversion or loss. A dynasty trust drafted with sufficient built-in flexibility and control can actually provide descendants with all of the advantages of a trust, while offering a level of indirect control and enjoyment that may closely mirror outright ownership.

Nonetheless it may be challenging for wealth planners to convince clients who assume that using trusts is tax motivated or only needed to protect the very young that a bequest in trust can provide beneficiaries with superior enjoyment of the family wealth and many important additional protections that cannot be achieved otherwise.

Beneficiaries may possess many rights and powers over assets held in trust without incurring adverse gift (and if applicable, estate and GST tax) consequences or exposing the assets to creditor claims. There are many important non-tax motivations for creating trusts irrespective of estate tax planning. These motivations should be important to both the settlor and the beneficiaries.

1. <u>Repeal Means Many Planning Opportunities.</u>

Many believe that without an estate tax to motivate estate planning, estate planning practices will dry up because wealthy and upper middle-class clients will no longer need to create credit shelter trusts, GST tax exempt trusts, marital trusts, or other trust structures created principally for transfer tax planning purposes. The practice of planners who primarily assist clients with estate freeze and estate reduction techniques, such as preparing grantor retained annuity trusts ("GRATs"), qualified personal residence trusts ("QPRTs"), or credit shelter trusts, will see their practice change. But repeal will produce untold complications and planning opportunities that will expand, rather than contract, most planners' practices. At first glance it may appear that repeal will reduce the number of trusts being created, but repeal will actually make properly designed dynasty trusts a vitally important and powerful testamentary planning tool that will place the family in the best possible position to protect assets from creditors, avoid or minimize state income taxes, increase family wealth outside of the transfer tax system forever, and react positively to the inevitable, but as yet unpredictable, future developments in the tax laws.

Historically, the size of perpetual dynasty trusts has been effectively capped at the maximum GST tax exemption amount. Clients have been forced to use installment sales, valuation discounts and other techniques to shift assets into their dynasty trust before death. Without an estate or GST tax, the main impediment to testamentary planning will be eliminated and all clients with an estate that potentially exceeds even the lowest exemption limits over the last 20 years would be well advised to fund a flexible perpetual dynasty trust with all of their assets to protect against the potential imposition of a future transfer tax. It would be highly tax-inefficient for decedents to pass wealth directly into the hands of their children, possibly subjecting it to a future estate tax. Indeed, it will become conventional wisdom for virtually every estate planning client to transfer all of their assets at death to a flexibly drafted dynasty trust that remains free from transfer tax forever. Estate and GST tax repeal will undoubtedly give the wealthiest clients the greatest estate planning opportunity.

If the gift tax is retained following repeal, avoiding gift taxes without delaying intergenerational wealth transfers until death, and planning to minimize the impact of a carry-over basis or capital gains tax regime, will become the most challenging transfer tax problems requiring expert planning advice.

If the gift tax is also repealed, "Put it all in trust", as many estate planners have long recommended, will become profound advice.[30]

2. Updating Estate Plans

For years following repeal, client documents will require updates, and decedents dying unexpectedly with old estate planning documents will undoubtedly cause issues and complications that will need to be solved, including post-mortem planning. In 2010, many descendants died with out-of-date estate plans, or plans failing to pass assets in the most tax efficient manner, or passing assets to individuals or organizations in an unintended manner if the decedent knew (had known) there would be no estate tax. Some estate plans use formula clauses that do not properly account for the possibility of repeal, or cause ambiguities with repeal, or fund trusts based on factual "if then" scenarios without taking into account the settlor's intent regarding repeal. Many estate plans give children withdrawal rights at certain ages, which would be far more tax efficient if they funded GST exempt dynasty trusts for many generations. Funding marital QTIP trusts just to defer estate taxes might be unnecessary with repeal, and could instead pass assets outright to descendants, the surviving spouse or, better yet, to a perpetual trust outside the transfer tax system. Formula clauses might cause some documents to by-pass the surviving spouse altogether, passing everything to the children and leaving the surviving spouse with no means of support. Many documents could raise litigation over construction issues. All of these estate plans will need to be reviewed and revised and, when clients die with such estate plans, advisers will need to perform post-mortem analysis to identify planning opportunities and concerns. Furthermore, all existing clients will need to have their estate plans evaluated and revised to include proper formula clauses and dispositive scenarios that take maximum advantage of repeal and properly implement settlor intent under the new laws. There will be many years of work adapting to the new reality of estate and GST tax repeal. Just consider most planners' experience toward the end of the year 2012, when it was widely thought that the $5 million estate and GST tax exemption was a limited one-time opportunity that needed to be taken advantage of quickly. The number of trusts and trust assets under administration ballooned in 2012, and most planners worked around the clock to accommodate clients' needs to create and fund trusts before the opportunity to take advantage of the sizable exemptions disappeared. Of course, the $5 million exemption was made "permanent" and indexed for inflation in the eleventh hour by the Taxpayer Relief Act of 2012, signed into law on January 2, 2013. There has continued to be a tremendous amount of planning under this historically high cap on the amounts that can fund dynasty trusts, and this work will undoubtedly continue following repeal.

3. GST Planning

If there is no GST tax, then modifications to GST non-exempt trusts and GST transfers can could occur without adverse GST tax consequences. During 2010, when there was no GST tax, many planners triggered GST transfers through direct skips and transfers to, and modifications of, GST non-exempt trusts. At the very end of 2010, when it was clear that the estate and GST tax would soon return, many planners extended the life and tax efficiency of GST non-exempt trusts by intentionally triggering a 0% GST tax under the 2010 Tax Act with a taxable termination or taxable distribution by decanting or otherwise modifying trusts to distribute assets outright to skip persons, terminate trusts, or eliminate the interests of non-skip beneficiaries (*e.g.*,. the transferor's children).[31] If the GST tax is repealed, those strategies will once again become useful any trust

[30] *See* J. Blattmachr, "*Even Without an Estate Tax the Right Answer is Still the Same: Put it all in Trust,"* https://www.thewealthadvisor.com/article/even-without-estate-tax-right-answer-still-same-put-it-all-trust.
[31] Section 302(c) of the 2010 Tax Act provided: "In the case of any generation-skipping transfer made after December 31, 2009, and before January 1, 2011, the applicable rate determined under section 2641(a) of the Internal Revenue code of 1986 shall be zero."

that is not already exempt from GST tax, irrevocable life insurance trusts and long-term trusts that capture the remainder interest of a GRAT.[32]

There may also be planning opportunities related to GST tax exempt trusts. Under current law, modifications to GST exempt trusts such as divisions, settlement agreements, decanting, judicial and non-judicial modifications, and certain constructions cannot be made without losing GST exempt status unless the modifications fall within the safe harbors found in the Treasury Regulations.[33] On the other hand, without a GST tax, GST exempt trust may be modified without fear of loss of tax benefits. So long as the modification would not implicate gift or income taxes, it could be made, even to extend the duration of a trust to enhance its exemption from taxation.

Without an estate or GST tax, it may be advisable to trigger inclusion in a beneficiary's estate to identify a new transferor for GST tax purposes, to extend the duration of a trust, or to possibly get a step-up in basis using the techniques discussed below.[34]

C. From a Model T to a Tesla: Flexibility and Future-Proofing.

Henry Ford's Model T was the original automobile made available to the world, and it was a perfectly good automobile to get drivers from point A to point B. It had four wheels, an enclosure and a steering wheel to direct where you go; all of the necessary components for its time. But the Model T lacks most of the modern features that automobile owners have come to expect as standard today. While Henry Ford probably never dreamed of including air conditioning or electric windows, let alone wireless phone capability, no one would purchase a car without those features today. And what about options that do not even exist at the time the automobile rolls off the assembly line? Today, manufacturers like Tesla offer free, automatic, over-the-air firmware updates for life, offering owners the possibility of future-proofing their automobiles to receive all available features created in the future, even auto-steering.

The point is that the estate planner, who undertakes drafting a dynasty trust that will survive every person living on the planet today, needs to draft a Tesla, which contains every modern feature available today, plus the ability to achieve unlimited future software upgrades for life, permitting continuous adaptability to new developments in the field.

Anyone who has ever reviewed a trust instrument drafted in the first half of last century will notice that most of the standard features of a modern trust instrument are missing. The drafter probably never even imagined features that commonplace today. Many old instruments are highly constricted, fixing the situs, limiting the qualifications of trustees, limiting investment options, or even failing to include trustee removal and appointment provisions thus entrenching the trustee. In addition, perhaps due to a failure of imagination, drafters a generation ago often failed to include tools for flexibility to provide a means of adapting to new options available through modern trust laws, and changes in family situations, laws or taxes.

Because dynasty trusts can be virtually perpetual in duration, and many circumstances can change regarding the tax, economic, and political environment and the specific factual circumstances of the beneficiaries over generations, it is imperative that a dynasty trust be drafted with maximum flexibility in mind. A super-flexible dynasty trust could be drafted with many additional features to ensure that it can adapt and withstand the test of time. It should be drafted so that if the trust divides into per stirpital shares at the death of each generation, it is held for the primary beneficiary as well as his or her descendants as an open class who have purely discretionary sprinkle interests, to maximize flexibility. Strong consideration should be given to including express decanting, division, merger, administrative amendment and power of

[32] Generally, irrevocable life insurance trusts are not GST exempt because a gift of a present interest to a trust using a lapsing power of withdrawal (i.e. Crummey withdrawal right) is not GST exempt due to a lack of coordination between the gift tax annual exclusion and GST tax annual exclusion. *See* I.R.C. § 2642(c)(2). Similarly, the remainder interest of a GRAT is generally not GST tax exempt because no allocation of GST exemption can be made until the GRAT term expires. *See* I.R.C. § 2642(f).
[33] Reg. § 26.2601-1(b)(4).
[34] *See* 25 Del. C. § 504; *see also* I.R.C. § 2041(a)(3); Reg. § 20.2041-3(e)(1)(ii).

appointment provisions, which may go beyond the scope of what is permissible under applicable state statutes, to enable changing the trust terms in the future. Additionally, the trust could include the role of a non-fiduciary "selector," who can add or remove beneficiaries, and a "trust protector," who can hold a variety of powers defined in the document, such as changing the trust situs and governing law, appointing and removing trustees, receiving accounts and binding beneficiaries, and making other decisions. When drafting a dynasty trust, it is very important to ensure that the mechanisms for appointing trustees, direction advisers, selectors and trust protectors will continue to operate appropriately even when all persons named are no longer serving or able to serve.

D. Enjoy protection from creditors and divorce claims.

A properly designed dynasty trust will protect trust assets from the claims of beneficiaries' creditors and reduce assets available to address spousal divorce claims if it includes a spendthrift clause and is governed by the laws of a state that protects trust assets from such claims. Trusts are one of the few estate planning tools that can provide liberal use, enjoyment and disposition of assets while avoiding taxes, creditors, divorce settlements and spendthrift heirs that may cause dissipation of family wealth. Although divorcing and former spouses continue to make claims against inherited property trusts, courts are generally without authority to order a trustee to divert the assets of a discretionary trust to persons who not beneficiaries, as distinct from (i) garnishing distributions when made, (ii) ordering a beneficiary to issue debt that could be paid from trust distributions, or (iii) taking trust assets into account when determining the disposition of marital property.[35]

E. Control investments.

A directed trust is a trust that includes a power of direction whereby an adviser or another trustee, who could be a beneficiary, directs the trustee in the exercise or non-exercise of certain powers relating to the administration of the trust.[36] One use of a trust director would be to direct the trustee's exercise of investment decisions pertaining to all or a portion of the assets. Descendants can control all investment decisions or certain special holdings like closely held entities, real estate and concentrated positions, by serving as the investment advisor or investment trustee of a directed trust. Alternatively, the beneficiaries may have a special relationship with a local investment manager other than the corporate fiduciary that has an office close to their residence and is better equipped to manage the family's investment needs in the trust. An individual with specialized expertise in running the family business that is held in a trust may possess the special skills required to make business decisions for that investment. The settlor may want to pass wealth down to successive generations through the use of a trust, but is not yet ready to turn over the investment management. Here, the settlor can retain the power to manage the trust investments by serving as the investment adviser and directing the trustee. In any of these situations, a directed trust can help facilitate the objectives of the settlor or beneficiaries where the trustee is unable or unwilling to do so. The investment responsibilities and liabilities can be assigned to an investment adviser, named in the trust instrument, and the trust instrument can require the trustee to act solely upon that investment adviser's direction.

In many instances, the trustee would not be prudent in holding the concentrated position, so the trustee would not be able to meet the settlor's needs. An exculpatory clause may not be sufficient to shield a trustee from liability, as under general principles of trust law, a trustee would be obligated to go to court for a variance should honoring the clause become detrimental to the beneficiaries.[37] An investment adviser

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[35] *See, e.g.*, Berlinger v. Castelberry, 133 So.3d 961 (FL App. 2 Dist. 2013) (court ordered a continuing writ of garnishment for unpaid alimony (in Berlinger v. Wells Fargo, N.A., 2015 WL 6125529 (11th Cir. 2016) the children subsequently unsuccessfully sued the corporate trustee for breach of duty for making distributions to their father to make alimony payments)); Ferri v. Powell-Ferri, 326 Conn. 438 (2017) (new trust that held decanted trust assets was not a self-settled trust even though the prior trust conferred presently exercisable withdrawal rights on the husband); Powell-Ferri v. Ferri 326 Conn. 457 (2017) (trial court did not abuse its discretion in failing to consider the value of an irrevocable trust created by husband's father as a marital asset).

[36] *See*, *e.g.*, UNIF. DIRECTED TRUST ACT (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2017).

[37] *See* RESTATEMENT (THIRD) OF TRUSTS § 66 (2003), Comment on Subsection (2): ("*e. Duty and authority of trustee.* If circumstances exist that would justify judicial action with respect to an *administrative* provision under Subsection (1) of this

could have responsibility for directing the trustee with respect to all of the trust assets, some portion of the trust assets, or specific assets (sometimes referred to as "Special Holdings" or "Special Assets"). In that case, liability for a concentration would be shifted to the investment advisor, who may be held to a lesser standard of care than a trustee would be. Often, the investment adviser will be responsible for directing the valuation of assets subject to direction, particularly when values are not readily available on a public exchange. There are many reasons why a settlor may wish to allocate responsibility for investment decisions to an investment adviser. One common reason is to enable the trust to hold specialized assets. An individual serving as investment adviser who knows the settlor (or may even be the settlor) may be more willing to hold an interest in a single limited liability company, or a closely held business or other special asset, and may be more in tune with the settlor's plans for future transactions involving a family-owned company or start-up. An individual with specialized expertise in running the family business may possess the special skills required to make business decisions for the company. A settlor may also want more than one investment manager for the trust assets. In that case, the trustee could be directed to allocate assets among multiple investment managers.

F. Control distributions.

Another common use for directed trusts is where a distribution adviser directs the trustee with respect to distribution powers. Settlors often want the responsibility for making trust distributions to belong to individuals who are close to the family and have personal knowledge of the beneficiaries' needs. This may be particularly desirable where a beneficiary has special needs or where the trust instrument includes lifestyle incentives or prohibitions that require personal knowledge and impose commitments of time and attention. Within limits, descendants can have control over distribution decisions by serving as the distribution advisor of a directed trust. Such powers should exclude the descendant as a beneficiary or be limited to an appropriate ascertainable standard described in section 2041(b).[38]

G. Remove and replace trustees and advisors and appoint a special purpose trustee.

Descendants can remove and appoint the trustee and any investment advisors, distribution advisors, trust protectors or any other power holder. Descendants can also have the power to appoint a special purpose trustee from time to time with exclusive power to exercise specific, limited or restricted powers, duties or responsibilities. The power to remove and appoint persons possessing powers that, if held by the beneficiary, would trigger a transfer tax, should be limited to successors who are not related or subordinate to the beneficiary within the meaning of section 672(c).[39]

H. Serve as a co-trustee.

Descendants could serve as a co-trustee of their trust, although that role should be carefully limited to avoid adverse transfer tax concerns that could arise if the gift and estate tax are in effect. For example, beneficiaries should not possess the power to make distributions to themselves, unless the distribution power is limited to an ascertainable standard.[40] It is possible that even an ascertainable standard would be

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Section, and if the trustee knows or should know of those circumstances and that substantial harm may result to the trust or its beneficiaries from adhering to the existing terms of the trust, the trustee is under a duty to initiate proceedings to seek appropriate modification of or deviation from that administrative provision."). In the charitable context, *see* In re Barnes Foundation, 683 A.2d 894 (Super. Ct. PA 1996) on the application of the doctrine of deviation.

[38] Note that trust property that a beneficiary may direct to himself or herself may be subject to the claims of his or her creditors in some cases even if the power is limited by an ascertainable standard. Cf. New York EPTL 10-7.2

[39] There may be adverse transfer tax consequences if a beneficiary possesses the power to remove and appoint trustees or other fiduciaries if the fiduciary has a power of distribution not limited by ascertainable standards or other power that might trigger a transfer tax if possessed by the beneficiary, unless the appointed trustee is not a related or subordinate party to the grantor under Section 672(c). *See, e.g.,* Rev. Rul. 95-58, 1995-2 C.B. 191 (relating to removal and replacement powers held by a settlor which has been extended by private letter rulings (not precedent) to similar powers held by a beneficiary).

[40] *See* Reg. §20.2041-1(c)(2).

insufficient to shield a beneficiary from taxation if the authority to distribute under a standard permits creditors of the beneficiary to require the beneficiary/trustee to make distributions.[41]

I. Use and enjoy assets.

The trustee can have discretion to permit beneficiaries to use and enjoy trust assets, with all of the advantages of assets held in trust, including continued immunity from transfer taxes and creditor protection. The trustee could also make and guarantee loans to beneficiaries or invest in a beneficiary's start-up business ventures. For example, a trust agreement could allow the trustee to purchase residential real estate and allow a beneficiary to live in the residence rent-free.[42] In fact, the agreement can allow beneficiaries to use any property owned by the trust, including things like boats, works of art or airplanes. The trust agreement also can allow a trustee to guarantee bank loans made to the beneficiaries, invest in business ventures owned or managed by beneficiaries or even make loans to the beneficiary to start up a business (or make loans to the business). Instead of making a large distribution to a beneficiary to purchase a home, if the trustee purchased the home within the trust and allowed the beneficiary to live in it, the value of that home could receive all of the tax and creditor benefits of other property held in trust.

J. Appoint assets at death or during life.

Beneficiaries can have a testamentary (or lifetime) limited power of appointment over a fully discretionary trust, thus giving the beneficiaries substantial control over the disposition of assets, effectively allowing them to make tax-free transfers among descendants, facilitate gifts to charities and change the dispositive plan. Note that in the case of a lifetime power of appointment, if it is exercisable by someone who is also a discretionary beneficiary, it is the IRS's view that the exercise is a taxable gift, the value of which is a question of fact.[43]

K. Save state income taxes.

Depending on the state in which the grantor and beneficiaries are domiciled, it may be possible to avoid all state income taxes on trust income and capital gains. If the dynasty trust is created in a jurisdiction that imposes no state income tax, the trust will avoid taxation in those taxing jurisdictions that base their income tax regime on the location of the trustee.[44]

L. Limit information.

In some jurisdictions, it is possible to limit or eliminate the information that some or all beneficiaries are entitled to receive for a period of time with a so-called "silent trust." A silent trust can be used by settlors who wish to restrict beneficiaries' rights to notice and information or accountings for a period of time. For example, the settlor of a very large trust may not wish for the beneficiaries to become aware of the trust until they reach a suitable age, in order to foster productive lives, careers and education and prevent the

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[41] *See, e.g.,* Estate of Maria Flood, NYLJ, 3/11/98, aff'd, 691 NYS 2d 354 (1999). The result in *Flood* was overridden by EPTL § 10-7.2 which now excepts property from being available to creditors if it is subject to a power of appointment exercisable solely for the support, maintenance, health and education of the donee within the meaning of section 2041 or 2514). However, there could be a concern that *Flood* is an expression of common law thus causing property subject to distribution by a beneficiary under a HEMS standard to be available to creditors, and therefore, subject to estate tax inclusion. *See* Rev. Rul. 76-103, 1976-1 C.B. 293; *Paolozzi v. Commissioner*, 23 T.C. 182 (1954); *Outwin v. Commissioner*, 76 T.C. 153 (1981); *Estate of Uhl v. Commissioner*, 25 T.C. 22 (1955).
[42] *See* Dickman v. Comm'r, 465 U.S. 330 (1984). Note, however, that in the case of a foreign trust, the rent-free use of property would be deemed a distribution of distributable net income in the amount of the rental value. *See* I.R.C. § 643(i).
[43] *See* Rev. Rul. 75-550, 1975 C.B. 357; Priv. Ltr. Rul. 200243026 (July 24, 2002) (not precedent); Priv. Ltr. Rul. 8608002 (Oct. 7 1985) (not precedent).
[44] *See, e.g.,* Fielding v. Comm'r of Rev., 2017 WL 2482593 (Minn Tax Ct. 2017) (motion for summary judgment granted to taxpayer in connection with a claim for refund who asserted violation of due process); Linn v Dept. of Rev., 2013 IL App (4th) (2013) (imposition of Illinois income tax on a trust found to violate due process); McNeil v. Commonwealth of Penn., 67 A.3d 1985 (2013) (residences of the settlor and discretionary beneficiaries are not sufficient presence to establish a nexus between the state and the trusts).

beneficiaries from becoming dependent upon the trust. This could facilitate goals such as avoiding the wealth becoming a disincentive for a productive life or preventing beneficiaries who reside in high risk locations or who have personal problems from being harmed by the source of wealth. A designated representative could receive informal accounts on behalf of beneficiaries, and is frequently insisted upon in order to permit the trustee to account. Silent trusts are also useful to validate so-called "blind trusts" for politicians and public officials.[45]

M. Promote productive lifestyles.

Trusts can include precatory language setting forth settlor values and wishes, creating incentives or precluding distributions in the case of drug or alcohol abuse, incarceration or other harmful behavior. Holding assets in trust, as opposed to outright ownership, can also prevent disincentivized heirs. At what age would a high-net-worth client want his children to inherit all of his wealth? Clients rarely want all of their wealth to pass immediately into the hands of their heirs, particularly if an untimely death would cause assets to fall into the hands of heirs who are unprepared to handle it. Clients with special assets, such as privately held businesses and real estate, often prefer such assets to be held in a trust, instead of passing outright to descendants. A dynasty trust can be drafted to provide the trustee with certain guidelines concerning distributions. For example, the settlor could express an intent that distributions not be made to or for the benefit of beneficiaries if the trustee believes the money could be used for any illegal purposes, or for drugs, alcohol or gambling, or in the case of a beneficiary who leads a life of unrepentant crime or self-destruction. Any such provision should give the trustee broad discretion to make a determination, including by relying on the judgment of other family members. A precatory provision authorizing a trustee to withhold distributions in that even, but not requiring it, will provide the greatest protection for a trustee. A provision authorizing a trustee to limit distributions to medical expenses in such a case can be beneficial.

The dispositive provisions could state that distributions should not be made for the expenses and costs of basic support and maintenance of a healthy, competent beneficiary who is of working age and not a full-time student. This would encourage such beneficiaries to pursue a career and become financially independent. The trust might also require achieving certain educational goals, although the instrument should permit deviation in the case of a beneficiary who achieve financial independence without attaining those goals. The settlor could express an intent that distributions be made for the benefit of a beneficiary who does not have sufficient assets for health insurance, disability or long-term care insurance coverage, regardless of any other guidance that might limit distributions.

The trust could also encourage beneficiaries to develop productive business skills by making loans to a beneficiary for a business enterprise in which a beneficiary is involved if such beneficiary possesses good judgment and financial acumen and if the beneficiary presents the trustee with a professional business plan that passes muster. An alternative could be for the trustee to split off a portion the assets into a separate trust of which the beneficiary as trustee controls investments and could thereby form or buy the business within the split off trust.

Any incentive language needs to be carefully drafted. Suggesting that distributions be made for certain purposes may provoke an action to compel a trustee to do so. Therefore, guidance that is not binding combined with a wholly discretionary trust is probably the most effective.

N. Protect special needs descendants.

Trusts can be designed to protect beneficiaries from losing governmental benefits such as, for example, Social Security Administration benefits, Medicaid and Supplemental Security Income benefits or any other benefits from any private or public profit or non-profit organization. The trust agreement could contain provisions to create a supplemental needs trust for a beneficiary so that it is possible to maximize that

[45] *See, e.g.* 12 Del. Cl. §§ 3303, 3339.

beneficiary's eligibility for governmental benefits while having supplemental needs met through the trust's assets.[46]

O. Protect assets from the return of the estate tax.

A dynasty trust that is designed to prevent federal estate tax inclusion or a GST tax under current law, and has enough flexibility within the document to adapt to changing circumstances in the future, should protect the assets held in the trust from any future gift, estate or GST tax, should those taxes ever return. If a dynasty trust is designed to avoid estate inclusion in the estates of the beneficiaries and the settlor, and to avoid taxable gifts by the beneficiaries, then the assets should be protected from future transfer taxes for so long as the assets remain in trust.

## III. Drafting For Flexibility.

Most of the provisions found in a trust's governing instrument reflect a choice between enhancing flexibility and imposing restrictions.[47] Whether it is intentional or not, drafting attorneys make choices in almost every trust provision they craft about how flexible the terms should be in light of the client's stated objectives. Those choices may be made in direct consultation with the client or, in many instances, effectively made by the drafting attorney on the client's behalf, depending upon the predilection of the attorney (and his or her forms) toward flexibility. One estate planning attorney has become known for the statement, "The disposition of the client's property is far too important a decision to be left up to the client." [48]

Basic trust provisions such as granting powers of appointment, allowing discretion or setting forth standards for distributions, removal and appointment of the trustee, choice of situs and governing law, or creating a directed trust, all reflect some degree of flexibility. Indeed, the fundamental characteristic of a trust involves fiduciary discretion. In contrast to an outright transfer of property or an executory set of instructions to an executor or agent, a trust grants authority to a trustee to take discretionary actions for the benefit of the beneficiaries in accordance with applicable fiduciary duties. By creating a trust, the settlor hands control over to the Trustee to carry out the settlor's intent. Even the drafting attorney's decision about whether to review each and every provision with the client can be viewed as the drafting attorney's value judgment on what the settlor's intent is regarding flexibility. And the client may rely upon the drafting attorney's informed judgment to advise on how the law and facts can (and will) change over time, making flexibility necessary or appropriate.

Yet, flexibility can be a double-edged sword. Too little flexibility can cause the trust to be too restrictive, resulting in the inability to accomplish desirable objectives in the future. Too little flexibility could require the parties to use more expensive and complicated techniques to modify the document, like decanting, merger, or court orders. However, too much flexibility can also be a problem if it permits the trustee or beneficiaries to trample over the settlor's intent or a material purpose of the trust. In some respects, one major component of the drafting process involves a balancing of the costs and benefits of flexibility in each area of the governing instrument, putting the drafting attorney in the role of the client's "flexibility adviser".

A. Powers To Decant, Merge, Amend.

The trust agreement may be drafted to permit the trustee to distribute trust assets to new trusts designed to meet changing needs or circumstances. A trust protector or the trustee can be given the power to amend the trust agreement to preserve favorable tax treatment, respond to changes in the law, or address changing economic conditions or family circumstances among the beneficiaries. Many modern governing instruments grant express decanting, merger and/or administrative amendment powers. These powers can

[46] *See, generally,* B. Krooks, *Creative Advocacy in Guardianship Settings: Medicaid and Estate Planning, Including Transfer of Assets, Supplemental Needs Trusts & Protection of Disabled Family Members*, NYSBA Guardianship Practice in New York.
[47] *See, generally,* S. Trytten, J. Blattmachr, M. Davis & S. Gorin, *Yes, I'll Order That Trust "Fully Loaded,* 50th Annual Heckerling Institute on Estate Planning, Special Session II-B (2017).
[48] I. Lustgarten & J. Blattmachr, *The Choice Between Pecuniary and Fractional Marital Deduction Formulas: The Ultimate Ambulatory Will*, 1980 Southern Cal. Tax Institute at ¶ 1300 ("the disposition of substantial property at death is too important and complex to be left to a testator").

be granted to the trustee or some other person such as a trust protector. These tools are frequently used to change administrative and dispositive provisions, bifurcate trustee responsibilities, transfer the situs of trusts, change governing law and accomplish a wide variety of other modifications.

Decades ago, it may have been much more difficult to change the provisions of an irrevocable trust.[49] Historically, courts tended to rely on doctrines such as deviation (which was limited to correcting administrative error's), scrivener's error and reformation, but now it is arguably much easier for interested parties to override the settlor's intent.[50] If the settlor wishes to include flexibility that will allow the trust to be changed to accommodate new developments in the future, the governing instrument should include express powers to decant, make administrative amendments, and merge the trust with another trust. Likewise, it should be possible for a governing instrument to expressly prohibit the use of any of these techniques under any applicable law, thus restricting flexibility and preventing beneficiaries from overriding the settlor's wishes.

Expressly authorizing these techniques, however, should be cautiously adapted by the drafting attorney and well documented as the settlor's intent to avoid claims by the future beneficiaries.

1. <u>Decanting.</u>

Decanting may be the single biggest development in trust flexibility. A more in-depth discussion of the legal and tax aspects of decanting is set for in Section IX.F. below.[51] In general, if the trustee has the discretion to distribute principal to one or more beneficiaries, a decanting power would authorize the trustee to exercise that power by making a distribution to another trust with different administrative and dispositive terms. Under most decanting statutes, a trustee with absolute discretion to make distributions to or among trust beneficiaries may instead distribute the principal of the first trust (and in some cases, the income) to a second trust for the benefit of one or more beneficiaries to whom such trustee could have made an outright distribution. If the trustee may invade the trust only pursuant to an enforceable distribution standard, many decanting statutes require that the distribution authority in the new trust replicate or otherwise comply with any such standard.

Decanting can be used to grant a power of appointment to a beneficiary that could even be exercised to distribute assets to persons who are not beneficiaries of the original trust. Decanting may also be used in some circumstances to eliminate beneficiaries. Although decanting, generally, cannot be used to expand beneficial interests, it can in many cases be used to modify them. Many states restrict the ability to modify certain administrative provisions, however, such as trustee compensation, reducing trustee liability in the second trust, or changing certain provisions pertaining to trustee succession. A governing instrument can include an express power to decant that is broader, and permits wider latitude to decant, than that found under applicable statutes. Decanting can be used to move the situs of a trust from one state to another, thereby allowing the trust to be governed by a different set of administrative rules than the ones the settlor originally selected.

Decanting does raises certain philosophical questions. The settlor may have given the trustee discretion to distribute principal to or for the benefit of one or more beneficiaries (subject to the fiduciaries duties of care and impartiality), but did the settlor foresee or intend anything like decanting? In some situations, could the application of a new statutory power over an older trust take flexibility too far? Balancing settlor intent with the opportunity to make changes through decanting has led some courts to decline to find a common law authority to decant in every trust.[52]

The following is an example of the kind of language that a drafter may wish to consider:

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[49] *But see infra* at section IX.F.

[50] *See* . UNIF. TRUST CODE, art. 4 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).

[51] *See generally*, UNIF. TRUST DECANTING ACT (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2015).

[52] *See* Ferri v. Powell-Ferri, 475 Mass. 651, 655 (2017); Morse v. Kraft, 466 Mass. 92, 99 (2013).

"Notwithstanding any other provision hereof, and without limitation of [Section 3528 of Title 12 of the Delaware Code] or any successor provision thereto, the Trustee may, at any time and for any reason, in the Trustee's sole and absolute discretion, pay over the net income and principal hereof to such extent, including the whole thereof, and in such amounts and proportions, including all for the benefit of one or more beneficiaries of the trust to the exclusion of the others, and at such time or times as the Trustee, in the exercise of sole and absolute discretion, shall determine, in favor of one or more further trusts to be held, administered and disposed of for the benefit of such one or more beneficiaries as the Trustee, in the exercise of sole and absolute discretion, shall determine. The terms of such trust or trusts may be different than the terms of the trust created hereunder in any manner, including, without limitation, any provision pertaining to the administration of any trust created hereunder. The Trustee shall have no liability whatsoever in connection with the exercise or non-exercise of the power described in this Section except in the case of the Trustee's own willful misconduct. It is the Grantor's intention that this provision provide the Trustee with the maximum flexibility to reconfigure the terms and conditions of any trust created hereunder to further the Grantor's intention and maximize the objectives of this Agreement and the trusts created hereunder and to accommodate developments in economics and finance, changes in family situations and changes in applicable law, including, without limitation, trust law and tax law, by enabling the Trustee to distribute the trust estate in favor of such trust or trusts, under such terms and conditions, as the Trustee deems appropriate."

2. <u>Merger.</u>

Many governing instruments and state statutes grant trustees a power to merge a trust with another trust, provided there is no material change to beneficial interests.[53] A trustee's power to merge two or more trusts, often by statute but occasionally under a governing instrument, may allow parties to change administrative provisions. The merger power can be used to effectively modify the administration provisions of a trust by merging the trust with and into a newly created trust that includes the desired modifications. Because the scope of the merger power is often limited to trusts with substantially identical beneficial provisions, merger may be an attractive option for making administrative changes but is usually not a viable option for making changes to beneficial interests. Some practitioners debate whether a trustee merge power can be used to create a new trust and merge an older trust into it to change administrative provisions, transfer situs, bifurcate trustee responsibility, and the like. Some argue that the use of a trust merger power should be limited to merely merging old existing trusts that are substantially identical, and cannot be used to create a new trust for the purpose of accomplishing a merger to modify trust terms.

The following is an example of language that a drafting attorney may wish to consider to confer the power to merge trusts:

"The Trustee shall have the power to merge all or any part of the assets of any trust created hereunder with the assets of any other trust created by the Grantor or any other person, including the Trustee (whether during life or by Will) that is held for the benefit of the same beneficiaries and upon substantially the same terms and conditions as those set forth herein, and at the Trustee's discretion, either (i) administer the merged assets as a single trust hereunder, or (ii) transfer the trust assets to that other trust, to be administered under the instrument governing that other trust, and thereafter terminate the trust hereunder."

3. <u>Power to Amend.</u>

Many trust instruments will reserve to the trustee, trust protector or other fiduciary a limited power to amend the provisions of the trust. Ordinarily, the scope of this power would prohibit changes to

[53] *See, e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 68 (2003); UNIF. TRUST CODE § 416 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).

beneficial interests or provisions specifically included to trigger a certain tax treatment; however, the grant of the power may be further limited to solely administrative changes, or changes necessary to preserve certain tax benefits intended by the settlor or otherwise fulfill the settlor's intent with respect to the trust. Some trust agreements permit even broader amendment powers, permitting modifications to dispositive provisions, or excluding or adding beneficiaries. If some power holder other than the trustee, such as a trust protector, possesses the power to make administrative amendments to the governing instrument, then this strategy is clearly the best approach for the trustee, because the discretionary action and all the risk are taken by another party.[54] An express administrative amendment power can be the quickest, easiest and lowest risk option for making changes to an existing trust.

The following is an example of the kind of language that a drafter may wish to consider:

> "The Trustee shall have all additional powers and authority necessary or desirable, in the sole judgment of the Trustee, for prompt and effective administration of the trusts created hereunder, unless the particular power or authority is specifically denied by this Agreement. The Trustee may amend any portion of this Agreement to state expressly any such additional powers and authority or otherwise to change the provisions of this Agreement in any manner that the Trustee deems necessary or advisable. Nevertheless, no power granted to the Trustee in this Section grants any implied power to change beneficial interests under any trust, or to amend this Agreement in any manner that would cause all or any portion of the trust estate to be includible in the gross estate of the Grantor or any trust beneficiary for estate tax purposes."
>
> "The [Trustee/Trust Protector] shall have the power to amend the administrative and technical provisions with respect to any trust hereunder, at such times as the [Trustee/Trust Protector] may deem appropriate for the proper administration of such trust, for tax purposes and/or to conform to the laws of any jurisdiction governing such trust. Notwithstanding the foregoing, the [Trustee/Trust Protector] shall have no power to amend this Agreement in any manner that would cause all or any portion of the trust estate to be includible in the gross estate of the Settlor or the Trust Protector for estate tax purposes."

4. <u>Non-judicial Settlement Agreement.</u>

More than half of all United States jurisdictions have adopted some form of the Uniform Trust Code (UTC),[55] which includes provisions for a non-judicial settlement agreement. Under such provisions, the trustees and beneficiaries of a trust may settle matters relating to a trust by private agreement, without the need for court involvement. In some states, a non-judicial settlement agreement may expressly be used to modify a trust. In others, modification is not specifically listed as one of the matters that can be addressed by an non-judicial settlement agreement, but there are other broad areas of relief that can be effective to accomplish beneficiary and trustee objectives

B. <u>Discretionary Distribution Power v. Standards.</u>

A governing instrument that allows the trustee to make distributions of income and principal to or for the benefit of one or more beneficiaries in the trustee's sole an absolute discretion allows for much greater flexibility than an instrument that permits distributions only pursuant to an ascertainable standard, in specific amounts or for specific purposes, or grants only an income interest. A discretionary trust for a class of beneficiaries can also offer a wide variety of decanting options, it can be preferable from a creditor protection standpoint, and can allow the trustee to withhold distributions to beneficiaries or make extraordinary distributions, as appropriate.

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[54] *See* discussion in Section IX.G.

[55] UNIF. TRUST CODE (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).

C. Incapacity.

Many documents define incapacity and, depending upon how it is defined, a governing instrument, could impose unnecessary limitations or create ambiguities or situations that are difficult to administer. A determination of incapacity should be based on objective criteria and triggered by written documentation. It can be beneficial to permit the succession of fiduciaries and others based upon a written statement by certain family members or a physician that the individual is longer capable, for health or other reasons, to fulfill his or her role. Note that a suggestion of incapacity would not, by itself, automatically remove a trustee from office without action by a court, unless an appropriate provision for removal or succession is contained in the governing instrument.[56] The governing instrument should account for the possibility that a power holder might become incapacitated.[57] A decision should be made whether an agent of the power holder should be permitted to exercise the power on the power holder's behalf. If that is desired, express authorization needs to be contained both in the governing instrument and in the power of attorney. The governing instrument should address the possibility that a beneficiary who has the power to approve the trustee's accounting, remove and appoint trustees, or receive notice of the trust might become incompetent. The same consideration is relevant to or the grantor's substitution power for grantor trust treatment.

The following is an example of the kind of language that a drafter may wish to consider:

> For all purposes of this Agreement, a person shall be conclusively presumed to be competent unless (i) the Trustee is unable, in the exercise of ordinary due diligence, to locate the person; or (ii) the Trustee has actual knowledge that the person has been adjudged incompetent or a guardian or conservator, or someone holding a similar office has been appointed by a court to care for the person or manage the person's property; or (iii) a physician notifies the Trustee in a signed writing that the person, by reason of physical or mental incapacity, is not able properly to manage and care for his or her property, or (iv) all of the person's spouse and adult children have unanimously certified in writing that the person is incapable of timely exercising the authority granted to such person under this Agreement. The Trustee may rely without further inquiry upon any court proceeding or writing of a physician or family member described in this Section and shall have no liability hereunder in doing so.

D. Pot Trusts.

Drafting a dynasty trust to continue as a so-called "pot trust" over multiple generations is typically discouraged, but could provide certain tax benefits. A pot trust can be problematic compared to a trust that divides for descendants per stirpes at each generation. Over time, the children and grandchildren will become a larger class, and they will have different needs for distributions, different investment needs and preferences, and may want different trustees. The beneficiaries of a pot trust typically want to split the trust into separate shares. Nonetheless, continuing a pot trust until all non-skip persons for GST tax purposes are no longer living, can extend the period during which a non-exempt trust remains sheltered from GST tax. Therefore, consideration should be given to continuing a pot trust, assuming appropriate fiduciaries are available to maintain the peace among the beneficiaries.

E. Precatory Language.

Precatory language regarding distributions can provide the trustee with guidance in making distributions that may aid in the administration of the trust. However, it might limit the trustee's willingness to exercise discretion if the language is treated by the trustee as essentially a requirement. Also, the wishes and desires expressed in precatory language could become outdated, irrelevant or inconsistent with changes to the settlor's desires. Many settlors wish to control the behavior of future generations by imposing standards of

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[56] *See generally* C. Handler, *The Ethical and Practical Considerations of Removing an Incapacitated Trustee*, 43 NYSBA Trusts and Estates Law Section Newsletter No. 2 (Summer 2010).

[57] Note that in the case of a foreign grantor trust that must be revocable at all times during the grantor's lifetime in order to achieve the desired tax treatment, the governing instrument should ensure that someone (an agent of the grantor) has the power to revoke or amend the trust if the grantor becomes incompetent.

conduct that a beneficiary must achieve in order to receive distributions, or creating incentives for beneficiaries to receive distributions. These provisions can be phrased using precatory or mandatory language and can impose prohibitions on certain conduct or incentives or rewards for achieving positive goals. For example, a settlor may impose obligations requiring beneficiaries to work, go to school, marry within a certain religion, start a business, and so forth. This approach is obviously an attempt to control from the grave that is in philosophical contrast with the concept of granting the trustee broad discretionary authority to make distributions.

The following are examples of the kind of precatory language that a drafter may wish to consider:

> The Trustee shall consider the following precatory guidance when making discretionary distributions to beneficiaries:
>
> (a) the Trustee shall be reserved in making distributions with a goal toward preserving trust principal and accumulating trust income, and protecting the trust fund from the beneficiaries' creditors;
>
> (b) the Trustee shall not make excessive or extravagant distributions to any beneficiary that would be inconsistent with the values and guiding principles demonstrated by the Grantor through the manner in which in which the Grantor raised, nurtured and provided for his children during his lifetime, it being the Grantor's intention that his descendants shall lead healthy, productive lives as contributing members of society, regardless of their field of interests or work, even if such field may include, for example and without limitation, the arts, humanities, business, medicine, science, education, philanthropy, agriculture, politics, theology, environmental causes, homemaking or any other productive endeavor;
>
> (c) except in cases of significant need, the Trustee should consider making distributions of income or principal to or for the benefit of any beneficiary hereunder, with the discretion to make a reasonable inquiry regarding a beneficiary's other resources outside of the trust estate, not in excess of an amount necessary to provide for such beneficiary's health, education, and general maintenance (the foregoing provision is not intended to create an enforceable ascertainable standard, but rather an expression of the Grantors' wishes with respect to the exercise of the Trustee's sole and absolute discretion);
>
> (d) whenever possible, the Trustee should consider allowing a beneficiary to use trust property, or make loans to a trust beneficiary, rather than make an outright distribution to such beneficiary;
>
> (e) the Trustee is encouraged to make distributions to or for the benefit of any beneficiary for his or her primary and secondary education and college and professional education at the graduate as well as the undergraduate level;
>
> (f) the Trustee may invest in or make loans to a business enterprise in which a beneficiary is involved, or loan money to such beneficiary in connection with such enterprise; provided that the Trustee, in the Trustee's sole and absolute discretion, deems such beneficiary to possess good judgment and financial acumen and the beneficiary presents the Trustee with a professional business plan concerning such enterprise upon which the Trustee can base an investment decision;
>
> (g) the Trustee may make distributions to or for the benefit of a beneficiary whom the Trustee, in the exercise of sole and absolute discretion, deems not to have sources of assets other than the trust fund that are adequate to acquire health insurance, long-term or short-term disability or long-term care insurance coverage for the beneficiary and/or his or her family;
>
> (h) the Trustee is encouraged to make distributions to or for the benefit of any beneficiary for his or her primary and secondary education and college and professional education at the

graduate as well as the undergraduate level, and such educational purposes may include various sorts of education relating to the education and development of the intellect, including, without limitation, schooling in a traditional university as well as education in trades, arts, music, sciences, theology and other types of non-traditional, life-enhancing education, as well as study trips that are primarily of an educational nature;

(i) the Trustee may encourage the entrepreneurial spirit of beneficiaries by investing in, making distributions to a beneficiary to invest in, making loans to a business enterprise in which a beneficiary is involved or invested in, or making loans to a beneficiary in connection with such enterprise; provided that the Trustee, in the Trustee's sole and absolute discretion, deems such beneficiary to possess good judgment and financial acumen and the beneficiary presents the Trustee with a professional business plan concerning such enterprise upon which the Trustee can base such a distribution or investment decision;

(j) the Trustee is discouraged from making distributions for the benefit of beneficiaries that may be used for any illegal purposes, for drugs, alcohol or gambling, for alimony payments, or for the expenses and costs of basic support and maintenance of a healthy, competent beneficiary who is between the ages of 18 and 60 and is not a full-time student, but has remained unemployed for more than one of the preceding two years; provided, however, that the Trustee is authorized to make a distribution for the benefit of a beneficiary directly to a qualified drug and/or alcohol treatment or rehabilitation facility (it is Grantor's intention with respect to the preceding provision that a working-age, healthy, competent beneficiary be expected to put forth reasonable effort to pursue a career and earn income from work); and

(k) the Trustee may, in its sole and absolute discretion, reduce or suspend, in whole or in part, for such time or times, any distributions to be made hereunder to any beneficiary of the trust if the beneficiary or his or her spouse, within three years prior to the time such distribution would otherwise occur: (1) has shown, in the reasonable judgment of the Trustee, evidence of addiction to alcohol, drugs or gambling, (2) has been convicted of a felony offense or any crime punishable by imprisonment or domestic violence, (3) is subject to a court order restraining such person from harassing, stalking or threatening another person, or (4) has demonstrated a persistent and recurring inability to manage properly his or her financial affairs.

F. <u>Use and Enjoyment of Trust Assets.</u>

The governing instrument may permit the beneficiaries to use trust assets, such as real estate, without making outright distributions to the beneficiaries. Similarly, the governing instrument could permit the trustee to make loans to a beneficiary for the purpose of starting a business, buying a home, and so forth. Providing the trustee with the flexibility to take these types of actions in lieu of making distributions can protect the assets of the trust from creditors, retain possible transfer tax benefits, and retain value for future generations, while benefiting the current beneficiaries of the trust.

The following are examples of the kind of language that a drafter may wish to consider:

(a) Notwithstanding any other provision of this Agreement, it is the Grantor's intention that the Trustee or the Governance Committee, as applicable, in the exercise of sole and absolute discretion, may permit any one or more of the Beneficiaries-in-use of any trust held pursuant to Articles SECOND or THIRD hereunder, to occupy any real property and to use any tangible personal property forming part of the trust on such terms as the Trustee or the Governance Committee, as applicable, in the exercise of sole and absolute discretion, may determine, whether for rent, rent-free, with or without consideration of payment of taxes, insurance, maintenance or ordinary repairs, or otherwise. Additionally, the Trustee or the Governance Committee, as applicable, in the exercise of sole and absolute discretion, may grant a term of years interest or a life estate with respect to any asset to any one or more of the beneficiaries of a trust created hereunder, as the Trustee or the Governance Committee, as applicable, in the exercise of sole and absolute discretion, may determine, and may retain the power to terminate the same, retaining the reversionary interest in the trust or for the benefit of any other beneficiary of the trust, and to make any property of any trust created hereunder available for the use and benefit of any beneficiary of the trust on such terms as the Trustee or the Governance Committee, as applicable, in the exercise of sole and absolute discretion, may determine. In addition, the Trustee may make loans for market value interest rates, without interest or at less than market rate interest to any beneficiary, and may enter into any other transaction or agreement, whether or not of a commercial nature, with any beneficiary which the Trustee or the Governance Committee, as applicable, in the exercise of sole and absolute discretion, may determine to reflect what would be the wishes of the Grantor. The Trustee may also guarantee the loans of any beneficiary, on either a secured or unsecured basis, in the Trustee's exercise of sole and absolute discretion. The Trustee may purchase a business from a beneficiary, at or below fair market value, and may borrow money for any such business, either alone or with other persons interested therein, and secure such loan or loans by a pledge or mortgage of any part of any trust estate, all as the Trustee or the Governance Committee, as applicable, in the exercise of sole and absolute discretion, may determine.

(b) Notwithstanding any other provision of this Agreement, but subject to the direction of the Governance Committee (as hereafter defined) and the requirements of any trust that qualified for a gift or estate tax marital deduction, if at any time the Trustee holds any residential real estate as a part of the trust estate of any trust held pursuant to Articles SECOND or THIRD hereunder, whether by contribution from any person or by acquisition by the Trustee, then the Trustee may continue to hold such residence in trust for so long as Trustee deems appropriate without any liability whatsoever for the decision to acquire, retain, lease, sell, transfer, exchange, convert or otherwise dispose of such residence. The Trustee or the Governance Committee, as applicable, may, in its sole and absolute discretion, permit any Beneficiary-in-use to reside in the residence without the payment of rent or other charge, for so long as the Trustee deems appropriate. The Trustee shall pay the real property taxes and expenses of insurance, repairs and improvements attributable to such residence from the other assets of the trust estate, if any. The Trustee shall pay the expenses for upkeep and maintenance of the residence from trust principal. No Beneficiary-in-use shall be required to give bond or furnish security with respect to such residence and shall not be liable for waste, damage, or destruction. Whenever any such residence is not occupied by a Beneficiary-in-use, the Trustee or the Governance Committee, as applicable, may, in its sole and absolute discretion, retain such residence for so long as the Trustee determines in its sole and absolute discretion. Whenever such residence is not occupied by a Beneficiary-in-use, Trustee or the Governance Committee, as applicable, may, in its sole and absolute discretion, make such residence income producing by renting such residence or may allow such residence to remain vacant. Any such residence so held as a part of the trust estate shall be held as a part of the principal of such trust and any net proceeds of the sale of the previously owned residence not so applied to the purchase of the new residence shall also remain a part of the principal of the trust. When the Trustee sells such residence, the Trustee shall add the proceeds of the sale to the principal of the trust estate, to be held, administered and disposed of in accordance with Articles SECOND or Article THIRD, as applicable, and the other provisions of this Agreement pertaining to such trust.

G. <u>Definition of Issue, Children, Descendants.</u>

The definitions of children, issue, and adopted descendants can present unique issues. For example, there are many instances of beneficiaries attempting strategic adult adoptions where the governing instrument does not place an age limit on adopted children being treated as descendants. Yet there are also instances where an age limit might have an unfair impact on a beneficiary (such as an elderly beneficiary with no children who treated step-children as his own for their entire lives and desires a late-life adult adoption to provide for the child). Some documents are drafted to exclude adopted descendants altogether, and the settlor's mindset regarding adopted family members could change in the future. Note that a modification to a trust to include adopted children may result in a taxable gift by the existing beneficiaries who have allowed their interests to be diluted.[58]

Identifying specific named individuals as the settlor's children can be beneficial (particularly in the case of a male settlor) so that the class of beneficiaries is closed, and outside third parties are prevented from coming forth and claiming to be a descendant of a large trust. But naming children or other beneficiaries can be overly restrictive and could preclude inclusion of future family relationships. It might become necessary to expressly deal with issues related to modern reproductive technology, like posthumously conceived children and sperm donor descendants. Provisions drafted today that do not address those issues could seem antiquated a few decades from now. This could become a particularly complicated issue for dynasty trusts. The manner in which a governing instrument defines children born out of wedlock can also be problematic. Should a trust instrument use a different definition for children born out of wedlock to a male descendant as opposed to a female descendant? Presumably, a female descendant will know the identity of children born to her but male descendants could have unknown or unacknowledged offspring.

The following are examples of the kind of language that a drafter may wish to consider:

> "Children. Except as otherwise expressly provided herein, a "child" of a designated person means the following:
>
> (a) Except as modified in subsection (c), the biological child of such designated person who was born prior to the death of such designated person, unless such person has formally given up his or her rights to the child either in a court proceeding or by written agreement; provided, however, that if the biological mother and biological father of such child were not married at the time of such child's birth, such person shall not be considered the child of such designated person for purposes of this Agreement, unless such designated person was identified as a parent of such child on such child's birth certificate or was, during the designated person's lifetime, adjudged by a court of competent jurisdiction to be the parent of such child[, or was openly and notoriously acknowledged by the designated person as his or her child].
>
> (b) A child adopted by the designated person in a court proceeding, the finality of which is not being contested by the adopting person, if the child is under eighteen (18) years of age at the time of adoption. A child adopted by the designated person on or after the child has attained eighteen (18) years of age shall not be considered the child of the designated person for purposes of this Agreement.
>
> (c) A child conceived and born using the genetic material of a designated person after the death of such designated person shall be considered the child of such designated person if all of the following conditions are met:
>
> (i) The child is in gestation within two (2) years after the death of such designated person;
>
> (ii) The designated person

[58] *Compare* Priv. Ltr. Rul. 200917004 (Dec. 16, 2008) (not precedent) *with* Priv. Ltr. Rul. 200031022 (April 27, 2000) (not precedent).

A. signed a record evidencing consent to the use of his or her genetic material after the death of such designated person; or

B. at his or her death, was the spouse of the child's surviving parent, which surviving parent caused such child to come into being, and such designated person had not signed a record evidencing lack of consent to use of his or her genetic material by the surviving spouse.

(d) The "children" of a designated person means every child of such designated person (determined in the manner set forth herein).

Descendants. The "descendants" of a designated person shall mean the children of such designated person, the children of such designated person's children, the children of the children of such designated person's children, and so on down through the generations (using the same principles at each generational level used to determine whether a person is a child of such designated person).

Heirs-at-Law. As used herein, the term "heirs-at-law" shall mean those persons other than creditors who would receive the personal property of the person designated under the laws then in force of the State under which this Agreement is interpreted, as if said person had died intestate on the date stipulated for distribution, unmarried and domiciled in said State, and in such shares as if said person had owned only the property constituting the trust estate of the trust to be distributed among such heirs-at-law."

## H. Silent Trusts.

Many settlors create so-called silent trusts in which some or all of the beneficiaries have limited rights to obtain information about the nature and extent of their interests in the trust. Silent trusts generally have a negative impact on flexibility and reflect a desire to control from the grave. Often the settlor's motivation is similar to the inclusion of incentive provisions – that the trust will be too large and the descendants will have a disincentive to work or will fall prey to the destructive influence of others, or the beneficiaries will develop self-destructive tendencies. Can the grantor be sure that far into the future, it will never be a good idea for beneficiaries to become aware of the trust regardless of the restrictions are imposed? Silent trusts can also become problematic when beneficiaries serve a role or function in the administration of the trust. For example, a prohibition on providing information to beneficiaries can come in conflict with a beneficiary's' role as Distribution Committee member, or powers to participate in the removal and appointment of fiduciaries, to receive accounts and issue a release when a trustee resigns or removed, or to exercise a Crummy withdrawal rights.

The following are examples of the kind of language that a drafter may wish to consider:

(a) During the lifetime of the Grantor, the Trustee shall be under no duty to inform any person having a beneficial interest in any trust created hereunder of the existence of any such trust or the nature and extent of that person's beneficial interest in, or rights with respect to, any such trust. Following the death of the Grantor, the Trustee shall be under no duty to inform any person, other than the [any beneficiary with the right to receive current distributions of income and principal] of each trust held hereunder, having a beneficial interest in any trust created hereunder of the existence of any such trust or the nature and extent of that person's beneficial interest in, or rights with respect to, any such trust.

(b) In accordance with Section 3303(a) of Title 12 of the Delaware Code, prior to the death of the Grantor, the Grantor directs that no Trustee of any trust created hereunder shall have a duty to furnish any information regarding such trust to any beneficiary thereof, and shall be under no duty to inform any person having a beneficial interest in any trust created hereunder of the existence of any such trust, the nature and extent of that person's beneficial interest in, or rights with respect to, any such trust, any information regarding the income or assets of the trust, or any information regarding the administration of the trust and/or any transactions made by the Trustee. Following the death of the Grantor, the Grantor specifically directs the Trustee of each such trust to provide information (specifically including, without limitation, the information referenced above) only pursuant to and in accordance the express direction of the Trust Protector. The Trust Protector is expressly authorized to direct the Trustee to provide varying amounts of information among some beneficiaries or to provide information to some beneficiaries of such trust while withholding the same information from other beneficiaries, or withholding information from all beneficiaries, for any period of time, hereby explicitly negating any duty of impartiality that the Trustee or Trust Protector would otherwise have. Finally, the Grantor specifically directs that the disclosure of any information (specifically including, without limitation, the information referenced above) to any current beneficiary or beneficiaries by the Trustee shall not be deemed to create an obligation to disclose the same or similar information to any future beneficiary or beneficiaries.

(c) Notwithstanding any other provision of this Agreement and in accordance with Section 3303(a) of Title 12 of the Delaware Code, the Trustee and any other fiduciary serving in accordance with the provisions of this Agreement shall not furnish any account statement to any beneficiary, or provide any such beneficiary of notice of the existence of the trust, until such time as [OPTION 1: the Trustee other fiduciary is directed to do so by the Grantor or the Trust Protector.] [OPTION 2: the beneficiary attains ______ years of age.] [OPTION 3: the Grantor becomes deceased.]

(d) Except to the extent necessary to notify beneficiaries of their withdrawal rights under <u>[any section granting Crummey withdrawal rights to beneficiaries]</u> and to provide any information about the trusts hereunder that a beneficiary may request in connection with the beneficiary's determination of whether to exercise any such withdrawal rights:

(e) Until the death of the Grantor no Trustee or Investment Adviser shall be under any duty to inform any person having a beneficial interest in any trust created hereunder of the existence of any such trust or the nature and extent of that person's beneficial interest in, or rights with respect to, any such trust. Following the death of the Grantor, no Trustee or Investment Adviser shall be under any duty to inform any person, other than the [any beneficiary with the right to receive current distributions of income and principal] (or, if he or she is a minor or otherwise incompetent, then [to such beneficiary's] Representative) of each trust held hereunder, of the existence of any such trust or the nature and extent of that person's beneficial interest in, or rights with respect to, any such trust.

(f) In accordance with Section 3303(a) of Title 12 of the Delaware Code, prior to _____________, the Grantor directs that no Trustee of any trust created hereunder shall have a duty (and any such duty under applicable law is hereby waived) to furnish any information regarding such trust to any beneficiary thereof, and shall be under no duty to inform any person having a beneficial interest in any trust created hereunder of the existence of any such trust, the nature and extent of that person's beneficial interest in, or rights with respect to, any such trust, any information regarding the income or assets of the trust, or any information regarding the administration of the trust and/or any transactions made by the Trustee. During such period of time, the Trustee may, in its sole and absolute discretion and without limitation of the express waiver of the duty to disclose information to beneficiaries hereunder, provide varying amounts of information among some beneficiaries or to provide information to some beneficiaries of such trust while withholding the same information from other beneficiaries, or withholding information from all beneficiaries, for any period of time, hereby explicitly negating any duty of impartiality that the Trustee would otherwise have. The Grantor specifically directs that the disclosure of any information (specifically including, without limitation, the information referenced above) to any current beneficiary or beneficiaries by the Trustee shall not be deemed to create an obligation to disclose the same or similar information to any future beneficiary or beneficiaries. Finally, the Trustee shall have no liability, absent such Trustee's own willful misconduct, in connection with any decision to provide, or not to provide, any information to any beneficiary in reliance on the provisions of this Section. Following _____________, the Trustee shall be under the duty to provide information to the beneficiaries of the trust in accordance with applicable law.

I. Powers of Appointment.

Granting a beneficiary an inter vivos or testamentary power of appointment shifts dispositive control to the beneficiaries and affords tremendous opportunities for the beneficiaries to exercise flexibility. A power of appointment might be exercisable in favor of the grantor's or power holder's descendants, or also include charities, or spouses. Many limited powers of appointment are drafted to permit an appointment to any person in the world (other than the beneficiary, or the beneficiary's estate, creditors, or creditors of the beneficiary's estate). Such powers of appointment give the beneficiaries control over their trust, to change it in accordance with their own estate plan, or to even terminate the trust.

J. Remove and Appoint Fiduciaries.

Including flexible authority to deal with succession of trustees and other persons performing a role under a trust agreement is particularly important in a dynasty trust. It is likely that named successors may become unwilling or unable to serve, and named persons with the authority to appoint successors may also become unable to exercise their authority. Therefore, drafting succession provisions that will be effective under all circumstances is critical to the administration of a long duration trust. In addition, granting someone the authority to remove trustees and others will also be an important protection for the beneficiaries. As a general matter, it is not advisable to give beneficiaries the ability to remove and replace trustees, even in the context of compliance with the applicable tax restrictions. This can lead to conflicts among beneficiaries, particularly in a discretionary trust, and will inevitably be used as a mechanism to force distributions. Coordination among provisions that provide for succession is important as well, particularly if more than one person, such as a beneficiary and a Trust Protector, has the ability to make appointments. An express statement as to which person has the final say if conflicting appointments are made will be key. In addition, it can be beneficial for the trust agreement expressly to provide that any appointment is revocable until it takes effect, that a succession of appointments may be made, and that conditions may be placed on an appointment (such as age restrictions, residence, and other matters). In addition, an express provision regarding acceptance of appointment is worthwhile so that there is clarity as to whether a named successor has or has not come into office. A provision that any person who is not a party to the trust agreement must accept by an acknowledged, written instrument delivered to the trustees would seem prudent.[59] One might also provide that if the acceptance instrument is not delivered within a certain number of days (30 days or 60 days, for example), the nominated successor is deemed to have renounced the appointment.

K. Directed Trust Provisions.

The use of trust protectors, direction advisers, special purpose trustees, independent trustees, and administrative trustees are all tools that facilitate flexibility. It has become commonplace for trust settlors

[59] There may be adverse transfer tax consequences if a beneficiary possesses the power to remove and appoint trustees or other fiduciaries if the fiduciary has a power of distribution not limited by ascertainable standards or other power that might trigger a transfer tax if possessed by the beneficiary, unless the appointed trustee is not a related or subordinate party to the grantor under I.R.C. § 672(c). See Rev. Rul. 95-58, 1995-2 C.B. 191.

to design so-called "directed trusts" and to transfer existing trusts to new jurisdictions to become modified as directed trusts. These trusts include provisions that allow for a separate adviser to direct the trustee on how to the exercise a variety of ministerial and discretionary responsibilities, such as investment decisions pertaining to all or a portion of the assets, tax reporting, distributions, transfer of trust situs, amendments to the governing instrument and timing and procedure for beneficiary notice and information. Permitting the beneficiaries to appoint separate fiduciaries to perform different functions is analogous to giving the beneficiaries the ability to select service providers from an al a carte menu instead of a pre-fixed menu where a single corporate trust department satisfies every role. Even if the grantor does not want an investment adviser or distribution adviser at the time the trust is created, it might be useful to include a provision that gives the option (the flexibility) to appoint an adviser and bifurcate responsibilities in the future. Beneficiaries and trustees of older trusts that were created before the modern proliferation of directed trusts frequently seek to modify their trust to add an investment direction adviser provision.

Should drafting attorneys at least have a conversation with their clients about providing for multiple fiduciary roles, if not at the inception of the trust, at least adding the option to appoint a separate adviser in the future?

In all events, any express drafting should take into account the potential for overlap in roles, the need to share information, and the appropriate level of exoneration for following the direction of others. The simplest example of a potential conflict would be a distribution advisor who directs a distribution of $100,000 and an investment advisor who refuses to make funds available. The potential for adverse tax consequences should also be carefully considered. For example, is an investment in a residence that is used by a beneficiary an investment decision or a distribution decision? Frequently a trust may permit the settlor or a beneficiary to serve as investment adviser, but if the investment advisor can determine the investment in personal use assets could that authority cause estate tax inclusion for the settlor or the beneficiary who participates? In that case, perhaps an independent distribution advisor should have all authority over decisions to invest in personal use assets, and not the investment advisor.[60]

L. <u>Special Purpose Trustee.</u>

A governing instrument can offer additional flexibility if it gives the beneficiaries or a trust protector the ability to appoint a so-called "Special Purpose Trustee" to carry out specific objectives, particularly those which include actions that the trustee may not be willing to take if an unforeseen need arises in the future.

The following is an example of the kind of language that a drafter may wish to consider:

> "The Trust Protector shall have the power, by written instrument delivered to the Trustee, to appoint one or more Trustees for one or more specific, limited or restricted purposes and to exercise specific, limited or restricted powers, duties or responsibilities (hereinafter referred to as a "Special Purpose Trustee") and shall also have the power to remove those powers, duties or responsibilities from the other Trustee or co-Trustees then serving. The document appointing a Special Purpose Trustee may specify (i) the powers, duties and responsibilities of the Special Purpose Trustee, (ii) the term of the service of the Special Purpose Trustee, and (iii) the compensation of the Special Purpose Trustee, all as specifically set forth in such document. The Special Purpose Trustee shall be removed and appointed in accordance with all of the applicable provisions, and subject to all applicable limitations, of this Agreement and under applicable law pertaining to the removal and appointment of the Trustee and shall have the same standard of liability and indemnification as the Trustee in accordance with the applicable provisions of this Agreement and under applicable law; provided, however, that the Trust Protector may provide in the appointment document that the Special Purpose Trustee shall have more limited liability than the Trustee under this Agreement. It is the Grantor's intent to facilitate the efficient administration of the trusts created hereunder, and the purpose of this provision is to effectively bifurcate certain functions from the other duties of the

[60] Note that in In re Trust under Will of Flint for the Benefit of Shadek, 118 A.3d 182 (Del. Ch. 2015) the court prohibited the trust to be modified into a directed trust in which the trustee would serve only an administrative role.

Trustee from time to time in order to effectuate the efficient administration of the trusts. The Trustee shall have no liability for any action or omission of a Special Purpose Trustee except in cases of the Trustee's own willful misconduct. Notwithstanding any other provision of this Agreement, neither the Grantor nor any beneficiary of any trust hereunder, nor any person or entity that is related or subordinate to the Grantor or any such beneficiary within the meaning of Section 672(c) of the Code shall ever be eligible to serve as a Special Purpose Trustee."

M. Express Virtual Representation.

Virtual representation is an important tool for the efficient resolution of trust matters in non-judicial matters such as beneficiary consents and releases as well as non-judicial settlement agreements. In its most basic form, virtual representation allows certain parties to represent and bind the interests of other parties. The underlying theory behind virtual representation is that, if the economic interests of the representative and the person being represented are substantially the same, and such interests would be affected in the same way by the proposed action, then the presence of the representative can be relied upon to raise any potential issues that the person represented would have made (or in the case of a consent, acquiring the representative's consent can insure that the proposed action would not have adversely affected the person being represented). Many states have enacted virtual representation statutes that set forth the parameters for when an adult beneficiary can represent minor, unborn, incapacitated and unascertainable beneficiaries. However, there are many states that do not have such clear laws, and some statutes are quite limiting. Drafting express virtual representation language in the dynasty trust instrument can provide flexibility and be useful in many judicial and non-judicial matters. Note, however, that not all such provisions will be respected, particularly if they attempt to abridge the rights of a beneficiary to enforce his or her interest in the trust.

It is typical for the holder of a general power of appointment to be able to represent the takers in default. However, certain states have enacted legislation that would also permit the holder of a limited power of appointment to represent the interests of the takers in default. The theory behind these statutes is that no particular taker in default has a mandatory interest in the trust. Instead, each taker in default's interest could be eliminated by the exercise of the limited power of appointment.[61]

N. Letter of Wishes.

A letter of wishes is a letter or statement containing precatory language that provides insight into the settlor's intent without becoming part of the mandatory trust language. A letter of wishes is usually a side document, not contained within the governing instrument itself and, therefore, it is generally not legally binding. A letter of wishes can be written and amended from time to time, at any time after the creation of the trust. This can be done without assistance of a lawyer, although it is prudent for the settlor to have a lawyer review to avoid the issues noted below. For example, if a trust is drafted as a discretionary sprinkle trust, a settlor could express the wish that his or her children be preferred when making distribution decisions, or the settlor could give guidelines similar to precatory language frequently found within trust instruments. Because a letter of wishes is not legally binding, a trustee cannot rely on a letter of wishes to avoid liability. Nonetheless, a letter of wishes may be persuasive with beneficiaries, particularly if its contents are made know to the beneficiaries while the settlor is still living, and accomplish greater acceptance of the administration of the trust consistently with the letter of wishes.

O. Trustee Powers.

Including a very broad list of trustee powers maximizes flexibility by allowing the trustee to take actions in the future that might not be anticipated at the time the trust is created. There could be unforeseen developments in the future, such as new investment opportunities or even new types of investment classes that do not even exist today that require actions the trustee must take in the future that could be prohibited without a broad, flexible set of powers. For example, trusts drafted a generation ago would not include powers to enter into derivative transactions or investments in limited liability companies, because those

[61] *See, e.g.*, FL. STAT. § 736.0302.

investments did not exist at the time. Because new investment opportunities will certainly be created in the future, the drafting attorney should include a general "catch-all" power to take all actions allowed by law. If desired by the settlor, such a provision combined with a waiver of the prudent investor rule discussed below will authorize a trustee to take advantage of these opportunities as they arise.

P. Waiver of Prudent Person Rule and Rule Against Self-Dealing.

Many governing instruments waive the prudent person rule or rule against self-dealing to enable the trustee wide latitude in making investments, including investments on a corporate trustee's own platform. The restrictions imposed by traditional trust portfolio diversification and asset allocation can inhibit portfolio growth and may be seen as overly restrictive under modern portfolio theory. Additionally, the rule against self-dealing is a strict prohibition on any investment in which the trustee has an interest, including affiliated investments, even if the terms of such investments are comparable to third party options. A waiver of the prudent person rule and the rule against self-dealing is generally included in a governing instrument to grant permission and flexibility (but not carte blanche) to the trustee to invest in an advantageous manner.

The following is an example of the kind of language that a drafter may wish to consider:

> "In addition to the investment powers conferred above, the Investment Adviser may direct the Trustee and the Trustee is authorized to acquire and retain investments not regarded as traditional for trusts, including investments that would be forbidden or would be regarded as imprudent, improper or unlawful by the "prudent person" rule, "prudent investor" rule, [Section 3302 of Title 12 of the Delaware Code], any rule or law concerning the duty of loyalty, or any other rule or law which restricts a fiduciary's capacity to invest. The Investment Adviser may direct the Trustee and the Trustee is authorized to invest in any type of property, wherever located, including any type of security option or derivative, improved or unimproved real property, and tangible or intangible personal property, and in any manner, including direct purchase, joint ventures, partnerships, limited partnerships, limited liability companies, corporations, mutual funds, business trusts or any other form of participation or ownership whatsoever. In making investments, the Investment Adviser and the Trustee, as applicable, may disregard any or all of the following factors: (1) whether a particular investment, or the trust investments collectively, will produce a reasonable rate of return or result in the preservation of principal; (2) whether the acquisition or retention of a particular investment or the trust investments collectively are consistent with any duty of impartiality as to the different beneficiaries; (3) whether the acquisition or retention of a particular investment or any aspect of the administration of the investment violates any duty of loyalty or rule against self-dealing; (4) whether the trust is diversified; and (5) whether any or all of the trust investments would traditionally be classified as too risky or speculative for trusts (the entire trust may be so invested). The Grantor's purpose in granting the foregoing authority is to modify the "prudent person" rule, "prudent investor" rule, the application of [Section 3302 of Title 12 of the Delaware Code], or any other rule or law which restricts a fiduciary's ability to invest insofar as any such rule or law would prohibit an investment or investments because of one or more factors listed above, or any other factor relating to the nature of the investment itself. The Grantor does this because the Grantor believes it is in the best interests of the beneficiaries of the trusts created hereunder to give the Investment Adviser and Trustee broad discretion in managing the assets of the trusts created hereunder.
>
> The Trustee is authorized to acquire and retain investments that would be forbidden or would be regarded as improper or unlawful under any rule or law concerning the duty of loyalty, any rule or law limiting, proscribing, or voiding or making voidable any interested party or self-dealing transaction, or any other rule or law which restricts a fiduciary's capacity to invest. The Trustee is authorized to acquire property from, transfer property to, obtain services from, provide services to, and otherwise enter into contracts, understandings, arrangements, and other dealings, of any kind or nature, with any person or entity, whether or not such person or entity is the Trustee or is in any

manner related to, or affiliated with, the Trustee or any other person or entity related to, or affiliated with, the Trustee and without regard to whether the Trustee, acting in its corporate or personal capacity or in any other capacity, or any person related to, or affiliated with, the Trustee has other contracts, understandings, arrangements or dealings, whether or not for remuneration, with the person or entity. The Trustee shall have the following powers and authorities:

To invest in any money market deposit or similar venture, account or securities of any Corporate Trustee Affiliate (as defined below), or in one or more limited partnerships, investment trusts, joint mutual funds or similar investment funds (each such enumerated investment is hereinafter referred to in this paragraph as an "investment fund") whether or not any Corporate Trustee Affiliate renders services to such investment fund, has a direct or indirect financial interest in such investment fund, or receives compensation therefrom. The Trustee shall be entitled to receive such compensation without providing notice or disclosure to any beneficiary as is provided in its published fee schedule for serving as Trustee as to amounts invested in any such investment fund even though a Corporate Trustee Affiliate may receive additional fees from such investment fund or may receive a brokerage, placement, finder's or similar fee from the trust created hereunder or from any third party in connection with the acquisition of any such investment fund and the Trustee shall have no duty or obligation to make disclosure or obtain any written beneficiary consents, whether or not described in [Section 3312 of Title 12 of the Delaware Code], or other applicable law, prior to making such investments.

To enter into transactions with, and to retain the services of, any Corporate Trustee Affiliate, upon such terms and conditions as the Trustee deems advisable, including, but not limited to, transactions in which, or service for which, a Corporate Trustee Affiliate (i) is a broker or dealer retained to execute security and any other transactions on behalf of the trust estate; (ii) acts as insurance broker, consultant, adviser or issuer or otherwise provides or issues insurance policies or other services pertaining to insurance; (iii) performs investment banking or similar services or acts as a financial adviser or consultant; (iv) purchases assets from or sells assets to the trust estate; (v) lends money to the trust estate or any entity in which the trust estate is invested; or (vi) engages in any other transactions (whether as an agent, as a principal, as a counterparty or in any other capacity) with, or renders any other services to, the trust estate. In such instances, the Corporate Trustee Affiliate shall be entitled to receive fees or other compensation from the trust estate or any entity in which the trust estate is invested without any reduction of the fees which the Trustee shall be otherwise entitled to receive from the trust estate.

The term "Corporate Trustee Affiliate" means (i) any trustee that is a corporation; (ii) any parent or subsidiary corporation of any corporation described in this paragraph; and (iii) any other entity, whether or not a corporation, affiliated with any corporation described in this paragraph."

Q. Discretionary Accelerated Division of Trust.

Include a provision that permits the division of the trust. For example, this could be used in a case where the trust will hold an asset or business in a jurisdiction that will cause the trust to be subject to income tax in that jurisdiction and it might be helpful to split the trust to segregate that source income in a separate trust so the remainder of the trust can continue to be exempt from income tax in that state. If a client establishes a dynasty trust that is a grantor trust during the grantor's lifetime, which will divide into per stirpital shares at the grantor's death, it may be useful to provide the flexibility that allows the trustee to divide the trust into per stirpital shares during the grantor's lifetime.

R. Optional Special Needs Trust Provisions.

A dynasty trusts that may benefit future generations could have a special needs beneficiary in the future. It might be advisable to include a provision that allows (or compels) the trustee to set aside a special needs trust for such a beneficiary upon the occurrence of some objective criteria.

The following is an example of the kind of language that a drafter may wish to consider:

> "during any such time or times when any of the [Trustee/Trust Protector/Distribution Committee] notifies the Trustee in writing that a beneficiary may be eligible for benefits from any local, state or Federal government, including, for example and not by way of limitation, Social Security Administration benefits, Medicaid and Supplemental Security Income benefits, or any other benefits from any private or public profit or non-profit organization, and that a so-called "special needs trust" or "supplemental needs trust" (each such trust is referred to hereinafter as a "Supplemental Needs Trust") could better maximize any such benefits available to such beneficiary, the Trustee may decant such part or all of such trust in which such beneficiary holds a beneficial interest in favor of a separate Supplemental Needs Trust [reference Special Needs Trust provisions in trust instrument].

S. Limitations on Trustee Qualifications or Situs.

Many older governing instruments place limits on the trustee's qualifications, such as: (a) limiting the geographic location of the trustee, (b) requiring certain levels of capital or assets under management of the trustee, (c) listing specific trust companies as the only entities qualified to serve as trustee, or (d) age restrictions on individuals serving as a fiduciary. Some governing instruments limit the ability to remove and appoint trustees to once within a certain period of years. These limitations can produce inflexibility to deal with changes in circumstances in the future.

T. Transfer of Situs and Governing Law.

Practically all modern governing instruments include provisions that expressly authorize a change of trust situs and place of administration. Many also permit the trustee or some other person to change the law governing administration to the new jurisdiction (or it may provide that such change happens automatically). Such provisions were more rare in older documents, and this advancement in drafting flexibility acknowledges that multi-jurisdictional trust planning and the increasingly migratory nature of trusts is an advancement in flexibility that has become commonplace.

The following is an example of the kind of language that a drafter may wish to consider:

> "The validity, construction and effect of the provisions of this Agreement in all respects shall be governed and regulated according to and by the laws of the State of Delaware. Except as otherwise provided in the following Section, each trust created hereunder shall be administered in accordance with the laws of Delaware, and the Trustee shall not be required to account in any court other than one of the courts of Delaware and shall have no duty to account in the courts of Delaware except to the extent provided hereafter. The original situs of the initial trust created hereunder shall be Delaware. The situs of any trust created hereunder may be maintained in any jurisdiction (including outside the United States), as the Trustee, in the exercise of sole and absolute discretion, may determine, and may thereafter be transferred at any time or times to any jurisdiction selected by the Trustee in accordance with the provisions of this Section. Upon any such change of situs, the trust estate may thereafter, at the election of the Trustee of said trust, be administered exclusively under the laws of (and subject, as required, to the exclusive supervision of the courts of) the jurisdiction to which it has been transferred. Accordingly, if the Trustee of any trust created hereunder elects to change the situs of any such trust, the Trustee is hereby relieved of any requirement of having to qualify in any other jurisdiction and of any requirement of having to account in any court of such other

jurisdiction. The foregoing authority of the Trustee does not impose a duty on the Trustee to monitor the laws of any jurisdiction other than the jurisdiction in which the trust is then administered."

U. Permitting Distributions Among a Broader "Class".

A settlor might identify a child as the "primary beneficiary" and permit discretionary distributions to the primary beneficiary and the primary beneficiary's descendants, as opposed to just the primary beneficiary. While the needs of the primary beneficiary take priority, permitting discretionary distributions to the broader class gives some flexibility to allow distributions to the lower generation if the need arises (for example, for education expenses, tax reasons, etc.). Having a broader class of current beneficiaries may also open more latitude to make changes through decanting.

IV. Addressing Future Tax Issues With Drafting Flexibility.

A. Why Would You Want Estate Inclusion?

Including the assets of a trust could be advantageous under certain circumstances. For example, depending upon the specific circumstances it could be advantageous to cause some of the assets of a dynasty trust to be included in the taxable estate of a beneficiary, if the estate tax exemption is very high, the beneficiary has all of his estate tax exemption available, and the trust has low-basis assets. In this situation, estate inclusion could provide a step-up in basis, without incurring any negative transfer tax consequences. Another example of a situation where it could be advantageous to cause the assets of a dynasty trust to be included in the taxable estate of a beneficiary is where trust assets are not GST tax exempt. By including the assets in the taxable estate, the trust could avoid the GST tax and use the beneficiary's estate tax shelter instead.

B. Springing General Power of Appointment.

One way to cause the assets of a dynasty trust to become includible in a beneficiary's estate is a so-called springing general power of appointment. This is accomplished by drafting language in the trust instrument that grants the trustee the discretion to give a beneficiary a general power of appointment, thus triggering estate tax under section 2041.

The following is an example of the kind of language that a drafter may wish to consider:

> The Trustee shall have the power to grant by notice in writing to the Primary Beneficiary of any trust under this Article a general power of appointment within the meaning of section 2041 of the Code over all or a portion of such trust, exercisable by his or her Will (or other testamentary instrument) making specific reference to this general power of appointment. The Trustee may also fully or partially revoke such grant of general power of appointment, by notice in writing to such Primary Beneficiary. The Trustee shall distribute the remaining and unappointed trust assets as otherwise directed hereunder.
>
> Contingent General Power of Appointment. Notwithstanding the provisions of any trust hereunder, if (a) pursuant thereto, upon the death of a beneficiary of such trust, any property would be set aside (outright or in further trust) for an individual assigned to a generation younger than the beneficiary's generation and (b) a generation-skipping transfer tax would be imposed on said property upon the death of the beneficiary, then the beneficiary shall have a "general power of appointment" (as defined in section 2041 of the Code) exercisable in favor of one or more creditors of the beneficiary's estate (and, if a power of appointment is granted to the beneficiary in such trust, in favor of any other permitted appointees of such power of appointment) over a portion of said property equal to the maximum amount that, when included in the beneficiary's "gross estate" (as defined in section 2031 of the Code), would result in a combined Federal and state estate tax on such portion in an amount less than the generation-skipping transfer tax that would have been imposed on such portion had it not been subject to said general power of

appointment. The Trustees may rely upon any written statement of the Personal Representatives or Administrators of the beneficiary's estate as to the maximum amount subject to said general power of appointment and shall have no duty to inquire as to the accuracy thereof.

The beneficiary may exercise said general power of appointment only by his or her Will, by any other written instrument executed with the same formalities as a Will or by a signed and notarized written instrument. Any property subject to said general power of appointment that is not so appointed shall be disposed of as provided in said trust.

Unless otherwise directed in a written notice delivered to the trustee by the Trust Protector, if any, otherwise the independent trustee, if a portion of a trust named for a beneficiary hereunder, in the absence of any testamentary power of appointment granted under the instrument to that beneficiary would immediately incur a federal generation-skipping transfer tax upon the beneficiary's death as a result of a taxable termination, then, in addition, to any other power of appointment granted to that beneficiary under this instrument, the beneficiary may appoint that portion of the trust to the creditors of his or her estate. In addition, with respect to a trust named for a beneficiary that is not fully exempt from the generation-skipping transfer tax, the Trust Protector, if any, otherwise the independent trustee, by written instrument filed with the trust records, may from time to time (i) grant to the beneficiary for whom the trust is named, in addition to any other power of appointment granted to that beneficiary under this instrument, a lifetime or testamentary power of appointment to appoint part or all of that trust to any one or more of (as determined by the Trust Protector or the independent trustee, as the case may be) the beneficiary, the beneficiary's estate or the creditors of either (a "general power of appointment"), or (ii) eliminate a general power of appointment in whole or in part, whether created pursuant to this paragraph or to another provision in this instrument. To the extent that a general power of appointment granted under this instrument is in existence on the beneficiary's death, then unless the beneficiary directs otherwise by will, the trustee shall pay to the personal representative of the beneficiary's estate, from the portion of the trust to which the power pertains, the amount, if any, by which the estate and inheritance taxes payable in any jurisdiction by reason of the beneficiary's death shall be increased as a result of the inclusion of that portion in the beneficiary's estate for such tax purposes, as certified in writing by that personal representative. In addition, if the beneficiary is treated as making a taxable gift with respect to the portion of the trust to which the power pertains, then the independent trustee may distribute to the beneficiary the amount, if any, of gift tax that may accrue as a result of that gift.

C. Delaware Tax Trap.

Another way to cause the assets of a dynasty trust to become includible in a beneficiary's estate is to use a testamentary limited power of appointment to intentionally trigger the so-called Delaware tax trap.[62] Section 2041(a)(3) relating to the estate taxation of powers of appointment, and section 2514(d) of the Code relating to lifetime transfers, are colloquially known as the "Delaware tax trap" because they were enacted in order to prevent estate and gift tax avoidance through the use of Delaware trusts. When the provisions were enacted in 1942, most states, including Delaware, applied the common law rule against perpetuities, which limited a trust's duration to lives in being when the trust was created plus 21 years. Where a trust instrument included a power of appointment, and the power holder exercised the power, most state laws required that the perpetuities measuring period relate back to the time the trust was originally created. Delaware, however, had a rule that when a power of appointment (whether general or special) was exercised, a new period for measuring the rule against perpetuities commenced upon the exercise of the power. Thus, for example, suppose that under Delaware law, a grantor created a trust with income to his son for life, and thereafter as the son might appoint. The son could appoint by granting his daughter income for life and granting her a power to appoint the remaining trust property upon her death, she could

[62] J. Blattmachr and J. Pennell, *Using "Delaware Tax Trap" to Avoid Generation Skipping Taxes*, 68 J. TAX'N 242 (Apr. 1988).

do the same for her child, and so on. Each exercise would start a new perpetuities period running, so that (absent section 2041(a)(3) and before the present Delaware rule against perpetuities), a Delaware trust could have lasted forever and not be subject to federal estate taxation. To deal with this Delaware problem, Congress enacted a rule embodied in sections 2041(a)(3) and 2514(d) which stated that if a power holder exercises a power of appointment created after October 21, 1942 by creating another power of appointment which under the applicable local law (i.e., Delaware) can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the creation of the first power, then the property subject to the power is includible in the gross estate of the person who creates the second power. Thus, looking at the law in Delaware at the time when the Delaware tax trap legislation was enacted, if a holder of a testamentary special power of appointment exercises that power to create another power of appointment, then upon the holder's death the entire trust corpus would be includible in the holder's gross estate for federal estate tax purposes.

Under current Delaware law, it is generally possible to exercise a limited power of appointment in a manner that will cause the property subject to the power to be included in the power holder's federal gross estate under the Delaware tax trap. Under Delaware law, a person can exercise a limited power of appointment in favor of a further trust which contains a limited power of appointment that can be exercised so as to postpone the vesting of the trust property for a period determined without regard to the date of the creation of the first power. Under section 2041(a)(3), if someone exercises a power of appointment in this fashion, the exercise will cause all of the assets subject to the exercised power of appointment to be included in the estate of the power holder. The beneficiary would exercise his or her power of appointment in favor of a further trust which contains a second power of appointment. This second trust could be written to last only a short period of time, such as six months, in order to trigger the Delaware tax trap and then distribute the assets to the beneficiaries' issue. In some instances, it may be an advantageous tax planning strategy to cause some or all of those assets to be included in the beneficiary's taxable estate. If such trusts are settled in Delaware, the power holders may, for example, elect to cause trust property to be included in their gross estates in order to avoid the imposition of the generation-skipping tax in cases where the power holder's estate tax rate is below the generation-skipping tax rate. It is also always possible to exercise the limited power of appointment in a fashion that does not cause the property subject to the power to be included in the power holder's federal gross estate. The assets subject to a power will not be includible in the power holder's taxable estate if the power holder either (1) does not exercise the power, (2) exercises the power but does not create another power of appointment, or (3) exercises the power so as to create another power of appointment, where the second power of appointment relates to the date of creation of the first power. Thus, for example, a power holder can obviously avoid estate taxation by not exercising his or her power over the assets that he or she does not want included in his or her estate. The power holder could also avoid estate taxation while exercising his or her power by exercising the power to create a further trust which does not contain a power of appointment. If desired, the power holder could design the new trust so that the trustee or trust protector of the new trust holds the powers that otherwise would have been given to a beneficiary power holder. Finally, the power holder could exercise the power in a fashion that creates a second power, however, he or she could provide in the instrument effecting the exercise that every estate or interest in property created through the exercise of the second power shall vest within a specified time period measured from the date of creation of the first power (for example, within 100 years following the creation of the first power). The Treasury Regulations expressly provide that property subject to a special power is includible in the power holder's gross estate under section 2401(c)(3) only if the second power created by the exercise of the first power can, under the terms of the instrument exercising the first power and applicable local law, be validly exercised so as to postpone vesting of the property for a period ascertainable without regard to the date of creation of the first power.[63] Therefore, in any case where the instrument exercising the first power expressly provides that all property subject to the second power must vest within a specified time period measured from the date of creation of the first power, it is clear that the property subject to the first power is not includible in the power holder's gross estate under section 2041(c)(3). The ability to utilize a limited power of appointment to either cause or avoid estate taxation can be a very useful tax planning opportunity because it provides a beneficiary with maximum flexibility in deciding exactly what amount of the assets in a trust shall be includible in his or her estate by purposely "triggering the trap" over the portion of assets that the beneficiary wants to have

[63] Reg. § 20.2041-3(e)(1)(ii).

included in his or her estate for tax planning purposes. This flexibility in Delaware's law does not exist under the laws of any other state.

V. Fiduciary Duty v. Flexibility.

A. The Inherent Tension.

There is an inherent tension between giving a trustee the discretion to take an action as a fiduciary, and the fiduciary risk that accompanies any discretionary act. Every discretionary power essentially creates fiduciary risk; risk that the beneficiaries could sue the trustee for acting or failing to act, in its discretion, in accordance with its fiduciary duties. Consequently, many of the tools for creating flexibility described herein produce fiduciary risk red flags for any fiduciary who would possess them. The discretionary acts trustee will be evaluated through the lens of traditional fiduciary duties, subject to an abuse of discretion standard and weighed against the exculpatory provisions and limitations on liability drafted in the trust instrument.

B. Reduced Standard of Liability: How Low Can You Go.

When choosing a jurisdiction for a trust, it is important to consider the outer limit of exculpation of trustee liability. In states that have adopted the Uniform Trust Code ("UTC"), the terms of a trust instrument cannot exculpate a trustee for bad faith or for reckless indifference with respect to the purposes of the trust or the interests of its beneficiaries.[64] The overwhelming majority of states that have non-judicial settlement agreement statutes have adopted UTC Section 1008. Although there does not appear to be a definition of reckless indifference in the UTC commentary or case law in the trust context, indifference implies that a fiduciary can be liable for breach of trust in the absence of taking an action or for an omission.[65] Other states that have not adopted the UTC permit greater exculpation of the trustee. For example, Delaware law provides that any provision in a trust instrument is enforceable except to the extent that it exculpates a trustee of liability for its own willful misconduct, which is defined as "intentional wrongdoing" (i.e. malicious conduct or conduct designed to defraud or seek an unconscionable advantage) rather than "mere negligence, gross negligence, or recklessness".[66] Additionally, the Court in *Mennen*[67] acknowledged that settlors are accorded wide latitude to structure their trusts in a manner that varies from the default statutory scheme or the common law is a hallmark of Delaware's Trust Act. The Court noted that prior to 2003, Delaware courts were precluded from exculpating a trustee from gross negligent conduct, however, the enactment of 12 Del. C. § 3303 overrides that principle with respect to trusts whenever created, and [t]his Court is bound by the General Assembly's instructions and the Trust Agreement's exculpatory clauses therefore must be read as excusing grossly negligent conduct. Other states such as Illinois, Idaho, do not appear to have statutes that set an outer limit for trustee liability. If the objective of a trust is to maximize flexibility, and maximize the use of tools available to the trustee to make changes or create flexibility, the trustee will want assurance that they can do so free from any risk of future liability. A state that leaves open the possibility of liability for accidental, inadvertent behavior based on some objective criteria of reasonableness may provide far less effective protection. A court can find reckless indifference in a case that involves carelessness or negligence if the damages are material because it is not necessary to prove knowing, intentional wrongdoing. Those jurisdictions that allow for exculpation for any conduct at all, or up to the limit of bad faith or willful misconduct provide a preferable legal environment to protect the parties.

C. Using Different Standards of Liability.

Drafters should consider using two separate standards of liability applicable to the trustee: a general and special standard of liability. The general standard of liability is the standard applicable to the trustee's

[64] UTC §§ 105; 1008.

[65] *See* RESTATEMENT (SECOND) OF TRUSTS § 222, Comment (1) (a trustee "is liable … if he acts or omits to act with reckless indifference as to the interest of the beneficiary.") (emphasis added)

[66] 12 Del. C. §§ 3301(g); 3303(a).

[67] Mennen v. Fiduciary Trust Int'l of Del., C.A. No. 8432 (Del. June 21, 20107) (order affirming judgment of the Delaware Court of Chancery).

conduct relating to the general administration of the trust. However, the special standard of liability can be used to help facilitate the corporate trustee taking actions that it might otherwise be reticent to take. For example, the special standard of liability could hold the trustee to a willful misconduct standard when it performs certain actions such as decanting, trust merger, granting powers of appointment, administrative amendments, or exercising a power to adjust. There is no reason why there must be only one standard of liability governing everything that the trustee will ever be asked to do. Jurisdictions such as Delaware permit a governing instrument to exculpate a trustee for any conduct except for willful misconduct. This may also eliminate the need to utilize a trust protector in the governing instrument to take these types of actions.

The following is an example of the kind of language that a drafter may wish to consider:

> General Standard of Liability. The Trustee shall be liable hereunder only for the Trustee's willful misconduct and gross negligence. In addition, the Trustee shall not be liable to anyone whose interests arise from this Agreement for breach of fiduciary duty in any case where the Trustee relied in good faith on the express provisions of this Agreement.
>
> Special Standard of Liability. Notwithstanding the foregoing, whenever, pursuant to the terms of this Agreement, the Trustee acts at the direction of the Investment Adviser, the Trust Protector or any other person authorized by the terms of this Agreement to direct the Trustee in the exercise of the Trustee's powers as to any particular matter, the Trustee shall have no liability with respect to such matter except in cases of the Trustee's own willful misconduct [alternatively "no liability" depending upon the jurisdiction]. In addition, the Trustee shall have no liability except for its own willful misconduct in connection with the following: [Identify and cross reference other powers of the trustee such as: (i) decanting powers, (ii) merger power, (iii) administrative amendment powers, (iv) power to adjust, (v) power to allocate between income and principal, (vi) power to divide the trust, (vii) power to transfer situs and change governing law, (viii) power to create a special needs trust, (ix) acts or omissions of other fiduciaries, (x) relying on determinations of incapacity, granting a springing general power of appointment, etc.]

## VI. The Fully-Adaptable Dynasty Trust.

Frequently, clients are understandably concerned about giving away a large portion of their wealth, and may want to retain the potential to someday access those assets again in the future. There are several options that planners can consider. Sometimes planners will consider completed gift asset protection trusts or a trust in which the grantor could be added as a beneficiary in the future, or the grantor could be the potential object of an exercise of a limited power of appointment that is exercisable by another person. Some states have enacted so-called asset protection trusts, and spendthrift statutes that provide adequate creditor protection for such structures which can help ensure that transfers can be treated as completed gifts.[68] Additionally, even after an irrevocable trust is created, there are options to modify the trust to include any provision that could have been included in the governing instrument of a trust that is created on the date of the modification on the written consent or written non-objection of the living trustor, all then living fiduciaries and all beneficiaries, either directly or through virtual representation.[69] Perhaps a bigger concern grantors frequently have is that while they want to make an irrevocable gift to a trust for beneficiaries, they recognize that the need to change the way the assets are ultimately disbursed from the trust, in the event of changed circumstances in the future. In other words, grantors often get cold feet about being permanently committed to an irrevocable structure.

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[68] *See* 12 Del. C. §§ 3570 et seq.; 12 Del. C. §§ 3536.

[69] *See* 12 Del. C. Section 3342; *see also* UNIF. TRUST CODE § 411 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010). Although such statutes should not cause inclusion in the grantor's taxable estate, s*ee* Private Letter Ruling 201233008 (March 28, 2012) (not precedent), the matter is certainly not free from doubt. The issue raised is whether the settlor's participation in a post formation modification implicates section 2036(a)(2) which causes property transferred during life with respect to which the settlor retained the right in conjunction with others (even if adverse) to control the disposition of the income of the trust. For that reason other states, such as Florida, do not permit non-judicial modification during the lifetime of the settlor. *See* FL. Stat. § 736.0412; *see also*, Powell v. Comm'r, 148 T.C. No. 18 (2017).

A. Case Study:

Mr. Controlling Moneybags would like to create a dynasty trust and fund it with shares of stock in his growing company. Mr. Controlling Moneybags is happily married and has a wonderful relationship with all of his children and grandchildren. Mr. Moneybags believes that the future of his company is bright and that the value of the stock will grow substantially. He has several friends who have created irrevocable perpetual trusts that were created as grantor trusts. But Mr. Moneybags has heard horror stories from many of those friends about their trusts. One of Mr. Moneybags' friends, Mr. Facebook, told him of a number of issues that he has with the dynasty trust that he created years ago. First, Mr. Facebook explained that his trust experienced an unexpected level growth, and the trust became much larger than he ever anticipated. Now Mr. Facebook has a $100 million trust for his descendants and he is gravely concerned that his descendants will never work a day in their lives and become unproductive, lazy trust fund babies. If Mr. Facebook had known just how large the trust would become, he would have provided for others, such as charities and siblings and nieces and nephews, to spread the wealth around. Second, Mr. Facebook got into a huge fight with the son years ago and stopped speaking to him. He wanted to change the trust so that the son and his family are no longer beneficiaries of the trust. Third, Mr. Facebook probably would have just given his estate outright to his children so they can simply have full access to use and enjoy it, rather than hassle with the expensive and restrictive structure of a trust; however, he is concerned about his conniving daughter-in-law getting his hard-earned fortune in a divorce settlement. Fourth, Mr. Facebook has been very concerned that the trust is about to sell the company stock, and Mr. Facebook is no going to have to pay enormous income tax on the capital gains because it is a grantor trust for federal income tax purposes. And lastly, Mr. Facebook remembers the financial meltdown of 2008, and he was very concerned when he set up his dynasty trust that someday he would run out of money, while his descendants are enjoying an enormous dynasty trust. Are there any planning recommendations for Mr. Controlling Moneybags that can solve all of these concerns?

In summary, Mr. Controlling Moneybags is concerned about (1) being locked into one irrevocable dispositive scheme, without being able to change the eventual recipients of the trust, (2) obtaining creditor protection but not overly limiting his children's access to the funds, (3) being saddled with large income taxes from the grantor trust, and (4) potentially benefiting from the trust assets someday if it becomes necessary.

1. Fully-Adaptable Dynasty Trust Is The Answer.

There is a dynasty trust structure that is so fully adaptable that it can satisfy all of these concerns and provide the most flexible and power wealth transfer vehicle imaginable. The plan begins with an inter vivos dynasty trust, drafted to incorporate all of the flexibility tools described above. The trust instrument will include express decanting and amendment powers, and the trustee will have very broad trustee powers and discretion over distributions to classes of beneficiaries. Such a structure will maximize flexibility. Next, the beneficiaries will be giving maximum flexibility, such as limited powers of appointment, and the power to remove and appoint all fiduciaries, transfer situs and choice of law, and they will even have the option to serve as investment direction advisers and possibly co-trustees. Lastly, the trustees will be given tools such as springing general power of appointment to address future tax problems. The flexible dynasty trust can include as many of the tools described above as the settlor wishes.

Next, the dynasty trust should be structured as a so-called "Spousal Lifetime Access Trust." Grantors who are concerned about giving away a large portion of their wealth, or who wish to ensure there's some ability to alter the provisions of an irrevocable trust, might consider a spousal lifetime access trust (SLAT). A SLAT is a trust that includes the grantor's spouse as a discretionary beneficiary, yet contributions to the trust are completed gifts for gift tax purposes because the trust does not satisfy the requirements of qualified terminable interest property under section 2523(f)(2). With this structure, the grantor's spouse could receive distributions from the trust. Consequently, a grantor who is happily married could make a completed gift to a SLAT, but also potentially benefit from the trust assets in the future if distributions are ever made to his or her spouse. Another powerful feature of the SLAT is the fact that although the grantor cannot possess the power to alter who receives the assets because that would cause estate inclusion under section 2036, the grantor's spouse can possess that right in the form of a limited power of appointment. The spouse could possess a lifetime or testamentary limited power of appointment that could be exercised to change the disposition of the trust assets without adverse transfer tax consequences. This flexibility is available as long as the spouse is alive and is a beneficiary of the SLAT, possessing that power. The trust could also provide that the spouse has a beneficial interest and a power of appointment only for so long as she is a qualified spouse, meaning married to and living with the settlor, and has not commenced any action for separate maintenance or divorce. The opportunity to change the disposition of the trust's assets will be lost once the spouse dies and the spouse could pre-decease the grantor, or ceases to be a qualified spouse. However, there is another tool that can be used to provide this flexibility, even following the death of the grantor and beyond.

The trust could include the role of a "selector" who possesses the non-fiduciary power to add and remove beneficiaries. Selector provisions are commonly used by planners to trigger grantor trust treatment, and have been used frequently in offshore trusts.[70] So long as the grantor's spouse is a beneficiary with the ability to receive discretionary distributions of both income and principal, the trust will be treated as a grantor trust for federal income tax purposes anyway, due to spousal attribution under section 677(a), and grantor trust treatment could not be turned off during the spouse's lifetime without removing the spouse as a beneficiary. While such provisions are often included as pro forma merely to trigger grantor trust treatment, it can be used to make the trust tremendously flexible and adaptable. The selector could even be used to remove the interest of the spouse. The selector can provide additional flexibility to alter the beneficiaries and remaindermen of irrevocable trust if the spouse dies before the grantor, which would have negated the flexibility afforded by the spouse's lifetime and testamentary powers of appointment. A selector could add charities, nieces and nephews or siblings of the grantor as beneficiaries of the trust.

B. Drafting for Tax Uncertainty.

On November 2, 2017, House Republican leaders released a draft of a proposed tax bill that would repeal the Federal estate and GST taxes after 6 years, increase the exemption to $10 million in the meantime, indexed for inflation, and also would retain the gift tax at a marginal rate of 35%. In addition, estates would continue to enjoy a basis adjustment at death under section 1014, as adjusted to reflect the repeal of the estate tax. Given all of these uncertainties, drafting an estate plan to accommodate all the potential permutations of future changes in the tax law is certainly a challenge for the drafting attorney. Exhibit 1 contains some sample language that would implement a so-called Clayton QTIP provision, combined with a disclaimer provision (in the event there is no estate tax) so that assets could be shifted by an independent fiduciary between a Marital Trust for the surviving spouse and a Family Trust. Certainly, one cannot risk leaving assets outright to beneficiaries when the estate tax may not be in effect upon the death of a client, but could be reinstated subsequently.

C. But suppose one is faced with an existing trust.

We do not always have the luxury of starting with a clean slate. Many times our clients come to us as beneficiaries of existing estate planning structures. They are driving a Model T. What opportunities do we have to turn our old and cold Model T trust into a Tesla trust without losing the tax benefits our Model T trust currently enjoys? The next sections of this article will analyze the law applicable to reforming and modifying existing trusts and the tax consequences of doing so..

## VII. A Refresher on the Law of Future Interests.

If long-duration trusts are here to stay, the need to change trusts after creation will become necessary. Whether state law will accommodate those efforts will depend on the particular state's common law and statutory law. States adopting the Uniform Trust Code (UTC) will find it contains numerous provisions dealing with the reformation, modification, amendment, and termination of irrevocable trusts. State law decanting statutes provide another means

[70] I.R.C. § 674(b)(5) (If the trustee is not an adverse party and any person has the power to add beneficiaries to the trust (other than to account for after-born or after-adopted children), the trust will be a grantor trust.)

to make changes to the administrative and dispositive provisions of an irrevocable trust.[71] Fiduciary law will control the remedies available when persons interested in an irrevocable trust wish to make changes. Assuming state law permits the changes sought, the tax consequences of those changes will depend in part on the nature of the property interests held by the various persons interested in the trust and in part on the circumstances giving rise to the proposed changes. Accordingly, to analyze the transfer tax consequences of making changes to an irrevocable trust, one must first understand the applicable property law.[72]

To analyze whether a modification, reformation, termination, or decanting of an interest in a trust estate has the potential to incur transfer tax, one must understand the nature of the property interests held and determine whether those interests are susceptible of gratuitous transfer. An interest in trust may be a present interest or a future interest. The law of future interests and its application in this context can be vexing.

In general, under the common law, transferees may hold three types of future interests: a vested remainder, a contingent remainder, and an executory interest.[73] For a remainder interest to vest, the transfer must give the interest to a presently ascertainable person, and the interest may not be subject to a condition precedent. A transfer to *A* for life, remainder to *A*'s descendants creates a contingent remainder because the class is not presently ascertainable. On the other hand, a transfer to *A* for life, remainder to *A*'s children creates a vested interest in *A*'s living children. Specifically, the interest of *A*'s children is a vested remainder subject to partial divestment by the birth of additional children. Although a transferor might create a condition precedent merely by placing a condition in the sentence of conveyance, a more refined description would note that the transfer incorporates the condition such that the condition becomes part of the transfer. For example, a transfer to *A* for life, then to *B* if *B* survives *A* creates a contingent remainder interest in *B* because the condition of survival is part and parcel of the transfer of the remainder interest. One should distinguish the language conferring a contingent remainder interest from a vested remainder subject to divestment: To *A* for life, then to *B*, but if *B* does not survive *A*, then to *C*. In this case, *B*'s interest vests subject to divestment upon failure of survival. *C*'s interest is an executory interest and will divest *B* should *B* fail to survive. Although the effect of both conditions is the same—that *B* does not succeed to the interest upon failing to survive *A*—the legal differences between a contingent remainder and a vested remainder subject to divestment are important. The latter is not subject to the rule against perpetuities, a result inherent in the fact that the interest is deemed vested. In addition, a vested remainder is subject to *inter vivos* transfer, while at common law a contingent remainder was generally inalienable.[74] Most states now allow, either by statute or case law, for the transfer of contingent remainders during life[75] and for the passing of vested remainders to the estate of the beneficiary, assuming they are not subject to a condition subsequent.[76]

[71] Decanting is the exercise of a trustee's power to invade the principal of a trust to transfer assets to another trust for one or more of the beneficiaries of the original trust. *See* FLA. STAT. ANN. § 736.04117; Phipps v. Palm Beach Trust Co., 196 So. 299 (1940). *See also*, T. Flubacher and A.M. Levin, *Put Decanting to Work to Give Breath to Trust Purpose*, Estate Planning (Jan. 2011).

[72] Changes to irrevocable trusts can also have income tax consequences, but those effects are beyond the scope of this paper.

[73] *See, e.g*., Wash. Legal Clinic for the Homeless v. Barry, 107 F. 3d 32, 40-41 (providing examples of future interests in the transferee); Presbyterian Church of Carlyle v. St. Louis Union Trust Co., 310 N.E. 2d 412, 417-18 (III. App. Ct. 1974) (describing the future interests of the transferee, which include remainders and executory interests); *see also* THOMAS E. ATKINSON ET AL., AMERICAN LAW OF PROPERTY § 4.25 at 451-54 (A. James Casner ed., 1952).

[74] *See* T.P. Gallanis, *The Future of Future Interests*, 60 WASH. & LEE L. REV. 513, 515-16 (2003). Nevertheless, holders of contingent interests were generally permitted to transfer the interest by contract if based on adequate consideration. *See* 1 LEWIS M. SIMES & ALLAN F. SMITH, THE LAW OF FUTURE INTERESTS § 395 (3d ed. 2011).

[75] *See* THOMAS P. GALLANIS & LAWRENCE W. WAGGONER, ESTATES, FUTURE INTERESTS AND POWERS OF APPOINTMENT IN A NUTSHELL 93 (4th ed. 2010); RESTATEMENT (THIRD) OF PROPERTY (WILLS & OTHER DONATIVE TRANSFERS) § 25.2 cmt. f (2011) ("All future interests are alienable and are also devisable and inheritable if the owner's death does not terminate the interest, unless the transferor has imposed a valid restraint on alienation.").

[76] *See* 17 AM. JUR. 2d, *Estates* § 204 (2004). Note that RESTATEMENT (THIRD) OF PROPERTY would abandon the distinction between a vested remainder subject to divestment and a contingent remainder, as well as the common law rule against perpetuities based on lives in being plus twenty-one years, in favor of a two-generation approach that would not require persons in the generation to be in being to be measuring lives. *See* RESTATEMENT (THIRD) OF PROPERTY (WILLS & OTHER DONATIVE TRANSFERS) § 25. 2 cmt. a and j 27.1 (2011).

In this regard, the Uniform Probate Code (UPC) section 2-707, which extends antilapse protection to future interests in trusts, effectuated an important change to the nature of future interests in trust.[77] States that have adopted the UPC amendment have in large measure eliminated, in connection with interests in trust, vested remainders and vested remainders subject to divestment by providing that, unless the trust instrument provides to the contrary, all future interests in trust are contingent on the beneficiary surviving the date of distribution. This is an important shift in the nature of future interests in trust because an interest that is no longer vested is not subject to devise by the holder of the interest. For example, a devise in trust, income to *A* for life, remainder to *A*'s child, *B*, would, under the UPC, require *B* to survive *A*. If *B* does not survive, the descendants of *B* succeed to the interest by right of representation. In contrast, were the interest treated as vested, *B*'s estate would succeed to the interest and his or her will or the laws of intestacy would dispose of it.[78]

Transferability of an interest should be distinguished from the question of whether a contingent interest is an interest in property. It seems that it is. Because it seems a contingent interest is a property interest, the issue is whether that interest is transferable. Under the common law, a contingent interest is not transferable until the contingency expires. Under current law, a contingent interest generally is transferable unless prohibited by the instrument establishing the interest.[79]

Interestingly, whether an interest is vested subject to divestment and therefore descendible continues to be the subject of litigation. In *In re DiBiasio*,[80] the decedent created a testamentary trust to provide for the care and support of his surviving siblings.[81] Upon the death of the last surviving sibling and following the payment of certain cash gifts, the trustee was to distribute the remainder to the decedent's nephew.[82] The nephew predeceased the sole surviving life tenant. The court held that the remainder vested upon the decedent's death, with the life estate operating only to postpone enjoyment.[83] Accordingly, the interest passed to the nephew's children.[84]

Courts have also applied the so-called preference for early vesting in the context of revocable trusts. In *First National Bank of Bar Harbor v. Anthony*,[85] the decedent created a revocable inter vivos trust retaining an income interest. Income was payable to the decedent's wife for life should she survive him, and upon the death of the survivor of the settlor and his wife, the trustee would divide the corpus into equal shares for the decedent's three children.[86] The court held that notwithstanding the settlor's power to revoke, the children's interests vested at the time of the trust's creation subject to defeasance by the exercise of the settlor's power of revocation.[87] Accordingly, the death of a child before the settlor did not defeat the interest of the child's heirs—the beneficiaries of the child's estate—who were entitled to one-third of the trust estate.[88]

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[77] *See* UNIF. PROBATE CODE § 2-707 (amended 2008), 8 pt. 1 U.L.A. 148-51 (Stipp. 2011).
[78] *See infra* text accompanying notes 79-92.
[79] *See* sources cited *supra* note 10.
[80] 705 A. 2d 972 (R.I. 1998).
[81] *See id*. at 973.
[82] *See id*.
[83] *See id*. at 973-75. The preference for early vesting will apply to avoid the lapse of a future holder's interest upon the holder's failing to survive the preceding estate. *See* In re Sheaf's Estate, 63 So. 2d 255, 256 (Fla. 1953); Travis v. Ashton, 23 So. 2d 725, 725-26 (Fla. 1945); Sorrels v. McNally, 105 So. 106, 108 (Fla. 1925). Thus, a future interest will vest at creation unless a court finds that "futurity is annexed to the substance of the gift." Travis, 23 So. 2d at 726; *see also* Davis v. Rex, 876 So. 2d 609, 613 (Fla. Dist. Ct. App. 2004) (holding a trust provision void for indefiniteness with respect to a beneficiary who died without issue). Note that the words *or his heir* indicate a substitution that creates a contingent remainder, whereas the words *and his heirs* create a vested remainder. *See* Rowett v. McFarland, 394 N.W. 2d 298, 305-07 (S.D. 1986).
[84] *See* DiBiasio, 705 A. 2d at 975.
[85] 557 A. 2d 957 (Me. 1989).
[86] *See id*.
[87] *See id*. at 959.
[88] *See id*. Other jurisdictions have held similarly. *See, e.g.*, First Galesburg Nat'l Bank & Trust Co. v. Robinson, 500 N.E. 2d 995, 997 (III. App. Ct. 1986) (holding grantors' children held vested remainder even if they predeceased the grantors); Hinds v. McNair, 413 N.E. 2d 586, 597-99 (Ind. Ct. App. 1980) (holding beneficiary's interest vested at trust's creation); Detroit Bank & Trust Co. v. Grout, 289 N.W. 2d 898, 909 (Mich. Ct. App. 1980) (holding beneficiary's interest vested at trust's creation).

Thus, the nature of the property interest continues to have importance for estate and gift tax purposes because it affects not only the interest's transferability but also its value.

## VIII. Defining the Transferred Property

### A. For Estate Tax Purposes

Article I, section 9 of the United States Constitution provides, "[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[89] A direct tax on wealth thus would seem to be unconstitutional. The estate tax is said to be, however, a tax on the transfer of property, not on its receipt.[90]

Estate tax value is based upon the aggregate assets includible in the decedent's gross estate at the moment of death.

> [T]he estate tax is laid only on that which passes at death, not what was owned before death or what the legatee receives after death. Since the tax is laid upon the decedent's estate as a whole, and not upon the property which is received by the various legatees, the valuation of decedent's assets, *at least for purposes of computing his gross taxable estate under section 2031*, can usually be made without reference to the destination of those assets.[91]

The moment of death means that potentially very brief moment before the interests of the subsequent beneficiaries vest when both restrictions on the decedent's ability to transfer property and value added by the decedent's presence end.

In *United States v. Land*,[92] the U.S. Court of Appeals for the Fifth Circuit described the moment of death as follows:

> Brief as is the instant of death, the court must pinpoint its valuation at this instant—the moment of truth, when the ownership of the decedent ends and the ownership of the successors begins. It is a fallacy, therefore, to argue value before–or–after death on the notion that valuation must be determined by the value either of the interest that ceases or of the interest that begins. Instead, the valuation is determined by *the interest that passes,* and the value of the interest before or after death is pertinent only as it serves to indicate the value *at* death. In the usual case death brings no change in the value of property. It is only in the few cases where death alters value, as well as ownership, that it is necessary to determine whether the value at the time of death reflects the change caused by death, for example, loss of services of a valuable partner to a small business.[93]

The property law principles governing a particular interest will impact its transfer at the time of decedent's death. In *Pierre v. Commissioner,*[94] the Tax Court described the relationship between state law determinations of property interests and federal taxation as follows:

> A fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights. It is

[89] U.S. CONST. art. 1, § 9.
[90] *See* Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929) ("The tax is on the act of the testator not on the receipt of property. . . ."); Ahmanson Found. v. United States, 674 F. 2d 761, 768 (9th Cir. 1981).
[91] Estate of Chenoweth v. Comm' r, 88 T.C. 1577, 1582 (1987) (citations omitted); *see also Ahmanson Found*., 674 F. 2d at 768 (distinguishing predistribution transformations and changes in value brought about by the testator's death from changes in value resulting from the assets of the gross estate coming to rest in different beneficiaries' hands under the decedent's estate plan).
[92] 303 F. 2d 170 (5th Cir. 1962).
[93] *Id.* at 172.
[94] 133 T.C. 24 (2009), *supplemented by* Pierre v. Comm'r, 99 T.C. Memo. 2010-106, 99 T.C.M. (CCH) 1436.

> well established that the Internal Revenue Code creates "no property rights but merely attaches consequences, federally defined, to rights created under state law."[95]

In *Morgan v. Commissioner,*[96] the Court disregarded the state law classification of a power of appointment as "special" because federal law classified the rights associated with that state law power of appointment (that is, the power to appoint to anyone, including the holder's estate and creditors) as a general power of appointment. Adhering to a pattern common in federal estate and gift tax cases, state law created the interest, which the Court respected and which the government taxed pursuant to the federal estate and gift tax provisions.[97] In short, the Court ignored the label, not the property interest created, and determined whether the interest fell within the federal statute. In *Knight v. Commissioner,*[98] the Tax Court followed the precedent set by *Morgan*: "State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights."[99]

Accordingly, the Tax Court in *Pierre* concluded that under New York law the donor had no property interest in the underlying assets of the LLC involved in the taxable gifts made by the taxpayer; thus, the interest that the donor transferred was, for federal gift tax purposes, an interest in the LLC, not the underlying assets of the LLC.[100]

An interest in property would appear to include any interest, even one that is contingent. Section 2033 applies to property in which the decedent had an interest and provides that "[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."[101] Treasury Regulation section 20.2033-1 clarifies the rule:

> The gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes under section 2033 the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death.[102]

Yet, the definition of gross estate must be interpreted by section 2001, which imposes a tax "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States."[103] Accordingly, two elements are necessary to impose an estate tax: an interest in property and the decedent's ability to transfer the interest at death. If the interest disappears at death—for example, if it is a contingent remainder interest with an unsatisfied condition—no estate tax is imposed.[104] For example, a trust providing income to *A* for life, remainder to *B* if *B* survives *A* constitutes a contingent remainder interest contingent on survival. If *B* predeceases *A*, no portion of the trust is included in *B*'s estate. *B*'s interest has evaporated. Similarly, in a state that has enacted UPC section 2-707, a trust providing income to *A* for life, remainder to *B* converts B's remainder interest to a contingent remainder conditional upon surviving *A*.[105] Thus, if *B* dies before *A*, no portion of the trust estate is included in *B*'s gross estate under section 2033.[106] However, in a state that has not enacted the abatement provision applicable to trusts, *B*'s interest would be a vested remainder interest and as such would be subject to transfer by *B* both during life and at death. *B* therefore has an interest subject to estate tax even if *B* does not survive *A*.

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95 *See id.* at 29 (quoting United States v. Nat'l Bank of Commerce, 472 U.S. 713, 722 (1985) (internal quotation marks omitted)).
96 309 U.S. 78 (1940).
97 *See id.* at 80-82.
98 115 T.C. 506 (2000).
99 *Id.* at 513 (citing Nat'l Bank of Commerce, 472 U.S. at 722).
100 Pierre, 133 T.C. at 30-31, 36.
101 I.R.C. § 2033.
102 Treas. Reg. § 20.2033-1(a).
103 I.R.C. § 2001(a).
104 *See generally* M. Gans, B. Crawford & J. Blattmachr, *The Estate Tax Fundamentals of Celebrity and Control*, 118 YALE L.J. POCKET PART 50 (2008); M. Gans, B. Crawford & J. Blattmachr, *Postmortem Rights of Publicity: The Federal Estate Tax Consequences of New State-Law Property Rights*, 117 YALE L.J. POCKET PART 203 (2008).
105 *See* UNIF. PROBATE CODE § 2-707(b) (amended 2008), 8 pt. 1 U.L.A. 149-50 (Supp. 2011).
106 *See id.*; I.R.C. § 2033.

While the foregoing appears fair in so far as *B* has a property interest susceptible of transfer, the vested remainder subject to divestment raises more concerns. Suppose a trust provides income to *A* for life, remainder to *B*, but if *B* does not survive *A*, then to *C*. Under the common law, the foregoing language would confer on *B* a vested remainder subject to divestment.[107] This distinction may not matter if the inquiry is estate tax inclusion. One will know at *B*'s death whether *B* survived *A*; if *B* did not survive, *B*'s interest will have lapsed upon *B*'s death. But if the condition did not operate simultaneously with *B*'s death, estate tax inclusion and the attendant valuation issues would arise.

Treating a remainder interest in a revocable trust as a vested remainder subject to divestment might surprise some. In Revenue Ruling 67-370, the Internal Revenue Service (Service) considered an *inter vivos* trust, controlled by New York law, under which the decedent or his estate was to receive the principal upon the death of the settlor.[108] The ruling notes that "[t]he settlor had reserved the right to modify, alter, or revoke the trust during her lifetime" and that "[s]ubsequent to the decedent's death, the settlor modified the trust and extinguished the estate's defeasible remainder interest."[109] The ruling holds:

> In providing that the value of the gross estate shall include the value of "all" property to the extent of the interest therein of the decedent at the time of his death, section 2033 is not affected by formal legal distinctions of nomenclature under state law. Therefore, it is not relevant to the application of section 2033 that a particular interest in property which survives the decedent's death may be either defeasible or indefeasible.
>
> Any determination of what would be the fair market value of a particular remainder interest like that under consideration herein would be affected by its possible curtailment or complete divestment at some point after decedent's death, in accordance with the general rules for the valuation of property which are set forth in section 20.2031-1(b) of the Estate Tax Regulations. The mere presence of these possibilities does not warrant the assignment of a merely nominal value to such a defeasible interest in any case where there is still a reasonable probability that the estate will actually acquire possession of at least some substantial portion of the property in question.[110]

However, depending on applicable state law, Revenue Ruling 67-370 might not apply to a more traditional revocable trust created for the primary benefit of its settlor during the settlor's lifetime. In *Darian v. Weymouth*,[111] the Florida District Court of Appeals determined that a devise, granted to the decedent's surviving spouse under the decedent's revocable trust and not conditioned upon the spouse's survival, nevertheless failed to vest prior to the decedent's death. The decedent created the revocable trust before the enactment of Florida's antilapse statute.[112] The spouse's adopted son killed the settlor and spouse, and the probate court deemed their deaths to be simultaneous.[113] The court cited the Florida Supreme Court case *Travis v. Ashton*, which held that if an element of futurity is annexed to the substance of the gift, rather than enjoyment of it, vesting is suspended and the gift is contingent.[114] Accordingly, in Florida, when the beneficiaries of a revocable trust do not come into possession of an interest until the settlor's death, the interest is contingent upon the settlor not exercising his power to revoke.[115]

In Revenue Ruling 76-472, the Service considered how to value vested remainder interests held by one of a class composed of a life tenant's issue.[116] The ruling states that, in general, future interests in property that a decedent owns at death are taxed just like possessory interests.[117] Thus, the value of a vested remainder

[107] *See, e.g.*, Crowley v. Engelke, 68 N.E. 2d 241, 273 (Ill. 1946).
[108] *See* Rev. Rul. 67-370, 1967-2 C.B. 324.
[109] *Id*. at 324.
[110] *Id*. at 325.
[111] 76 So. 3d 15 (Fla. Dist. Ct. App. 2011).
[112] *See id*. at 17.
[113] *See id*. at 17-18.
[114] *See id*. at 17 (citing Travis v. Ashton, 23 So. 2d 725, 727 (Fla. 1945)).
[115] *See id*. (citing Fla. Nat'l Bank of Palm Beach Cnty. v. Genova, 460 So. 2d 895, 897 (Fla. 1984)).
[116] *See* Rev. Rul. 76-472, 1976-2 C.B. 264.
[117] *See id*.

interest is includible in the value of a remainderman's would you be willing to change "remainderman" to "remainder beneficiary"? gross estate under section 2033, even though the remainderman dies before obtaining possession of the property:[118]

> In making the valuation, the actuarial value of the decedent's remainder interest, ascertained by the formula set forth in section 20.2031-10(d) of the regulations, should be the starting point. Consideration should then be given to all known facts and circumstances that might tend to decrease such value, with due regard for (1) the certainty that a woman who has reached the age of 53 years will not bear children is far greater than that attends most other human affairs and (2) the unlikelihood that a woman of that age will adopt a child.[119]

One wonders what advances in assisted reproductive technology might do to these kinds of computations and whether data even exists from which to analyze the probabilities.[120]

B. <u>For Gift Tax Purposes</u>

Treasury Regulation section 25.2511-2(a) provides the following:

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon [the] ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.[121]

The language of the regulation appears to leave open the opportunity to construe the gift tax as applicable to the donor's loss of value by treating that reduction as a transfer, even if no specific donee receives that value. Nevertheless, in Technical Advice Memorandum 9449001, the Service openly acknowledged that material differences exist in the administration of the gift tax and the estate tax, notwithstanding that the two taxes are generally construed in *pari materia*.[122] The estate tax is imposed on the "transfer of the taxable estate" of the decedent.[123] Under section 2051, taxable estate means the value determined by the deductions from the value of the gross estate.[124] Gross estate, in turn, means the value at the time of death of all the decedent's property.[125] In contrast, the law imposes gift tax on the property passing from the donor to each donee, and the value of that property is the basis for measuring the tax.[126]

With regard to both the estate tax and the gift tax, the transferor seemingly must begin with a property interest susceptible of transfer. However, gift tax law acknowledges that the specific identity of the donees

[118] *See id*.; I.R.C. § 2033.
[119] Rev. Rul. 76-472, 1976-2 C.B. 264.
[120] *See* In re Martin B., 841 N.Y.S. 2d 207, 207-08 (Sur. Ct. 2007) (permitting children conceived posthumously by decedent's widow to be included in the definition of *issue* and *descendants* for purposes of trusts created by decedent's father when decedent, knowing of his fatal illness, gave widow control of his semen for such purposes).
[121] Treas. Reg. § 25. 2511-2(a).
[122] *See* Tech. Adv. Mem. 9449001 (Mar. 11, 1994). Under section 6110(k)(3), neither a private letter ruling nor a technical advice memorandum may be cited or used as precedent. *See* I.R.C. § 6110(k)(3). However, under Treasury Regulation section 1.6662-4(d)(3), both may be considered authority for purposes of avoiding certain tax penalties. *See* Treas. Reg. § 1.6662-4(d)(3).
[123] I.R.C. § 2001(a).
[124] *See* I.R.C. § 2051.
[125] *See* I.R.C. § 2031(a).
[126] *See* Rushton v. Comm'r, 60 T.C. 272, 276 (1973), *aff'd*, 498 F. 2d 88 (5th Cir. 1974); Rev. Rul. 93-12, 1993-1 C.B. 202.

may be undefined and that a transfer may be implied based upon a loss in value to the property interests that the donor held.[127] Treasury Regulation section 25.2511-1(e) states the following:

> If a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred. . . . [I]f the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift. Thus if a donor, aged 65 years, transfers a life estate in property to A, aged 25 years, with remainder to A's issue, or in default of issue, with reversion to the donor, the gift tax will normally be applicable to the entire value of the property.[128]

Subsection (f) applies to the transfer of a limited interest in property:

> If a donor is the owner of only a limited interest in property, and transfers his entire interest, the interest is in every case to be valued by the rules set forth in §§ 25.2512-1 through 25.2512-7. If the interest is a remainder or reversion or other future interest, it is to be valued on the basis of actuarial principles set forth in § 25.2512-5, or if it is not susceptible of valuation in that manner, in accordance with the principles set forth in § 25.2512-1.[129]

Treasury Regulation § 25.2512-1 establishes, for gift tax purposes, the general valuation principle that the value of property transferred by gift "is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."[130] If a transfer is for consideration and the consideration is insufficient, the value of the gift equals the difference between the value of the property and the consideration in money or money's worth that the donor received in exchange for the property.[131] However, a transfer "made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."[132]

A transfer of a trust interest also may be subject to section 2702. Treasury Regulation § 25.2702-2(a)(2) provides that "[a] transfer in trust includes a transfer to a new or existing trust and an assignment of an interest in an existing trust," but does not include "[t]he exercise, release or lapse of a power of appointment over trust property that is not a transfer under chapter 12."[133] This means that the exercise would not diminish a property interest held in the trust by the power holder and that the power is not a general power of appointment within the meaning of section 2514.

Thus, a transferable property interest appears to be unnecessary to create a taxable gift. The relinquishment of a present or future interest in trust may be the subject of a gratuitous transfer, and the identity of the specific transferee is not needed. One must simply determine the value of the donor's interest before and after the transfer. To the extent the interest is one in trust—unless the donor's retained interest is a qualified retained interest within the meaning of section 2702 (or falls under an exception, such as for a transfer or an interest in a residence or a special rule applies, such as for certain tangible personal property or the statute does not apply because family members will never take under the transfer)—the law will likely assign the interest a zero value, transferring the entire interest held.[134] The law could potentially measure the transfer by either the loss of value to the donor or the tax consequences of holding that interest.

[127] See Treas. Reg. § 25.2511-2.
[128] *Id.* § 25.2511-1(e).
[129] *Id.* § 25.2511-1(f).
[130] *Id.* § 25.2512-1.
[131] *See id.* § 25.2512-8.
[132] *Id.*
[133] *Id.* § 25.2702-2(a)(2).
[134] *See* I.R.C. § 2702.

In *Smith v. Shaughnessy*,[135] the Supreme Court held that "the language of the gift tax statute, 'property . . . real or personal, tangible or intangible,' is broad enough to include property, however conceptual or contingent."[136] Accordingly, the Court held that a transfer of property granting a life estate, a remainder interest, and a reversion constituted a taxable gift to both the life estate and the remainder interest, even though the transfer was subject to a possible reversion if the donor survived the life tenant.[137] The dissent sought to frame the question in terms of whether the reversion negated the gift's completion until the donor relinquishes the interest,[138] but the majority was satisfied to rely on the appropriate actuarial computations.[139]

In *Commissioner v. Wemyss*,[140] the taxpayer entered into a prenuptial agreement whereby he agreed to transfer a block of stock to his fiancée to compensate her for the loss of an income interest in a trust upon remarriage. The Supreme Court found the transfer to be a gift "not made in the ordinary course of business."[141] The Court reinforced the lack of a requirement of donative intent, stating that "Congress chose not to require an ascertainment of what too often is an elusive state of mind."[142] The Court found that the exception for business transactions reinforced the breadth of the gift tax's application:

> To reinforce the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech, the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)."[143]

Even though a contingent interest may not be transferable, the inquiry may not end there. Section 2511(a) provides that the gift tax applies to gifts made indirectly.[144] The Treasury Regulations clarify that any transaction in which an interest in property is gratuitously passed to or conferred upon another may constitute a taxable gift, regardless of the device employed.[145] Courts have extended this rule to instances in which the taxpayer fails to enforce legal rights. For example, in *Lang v. Commissioner*,[146] a mother made a taxable gift to her son by failing to collect on loans made to the son and permitting the statute of limitations to expire. Similarly, relinquishing rights in a corporation—such as a right to dividends, a right to convert preferred stock to nonvoting preferred stock entitled to a cumulative dividend, and a right of purchase—may constitute a taxable gift.[147] The foregoing authorities, however, do not squarely cover the situation of a contingent interest in a trust. Because a contingent interest in trust is not typically transferable, the taxable transfer of a contingent interest is seemingly possible only if the contingent interest is given up. If one relinquishes a contingent interest other than by a qualified disclaimer within the meaning of section 2518, the degree to which that relinquishment enhances the value of property interests held by others may constitute a taxable gift.[148]

In *Jewett v. Commissioner*,[149] the Court held that the disclaimer of a contingent remainder interest, made decades after the original transfer in trust, was subject to gift tax. In reaching its holding, the Court determined that the "expansive reading of the statutory language in *Smith v. Shaughnessy* unquestionably

[135] 318 U.S. 176 (1942).
[136] *Id.* at 180.
[137] *See id.* at 181.
[138] *See id*. at 183 (Roberts, J., dissenting).
[139] *See id*. at 178 (majority opinion).
[140] 324 U.S. 303 (1945).
[141] *Id*. at 307.
[142] *Id*. at 306.
[143] *Id*.
[144] *See* I.R.C. § 2511(a).
[145] *See* Treas. Reg. § 25. 2511-1(1).
[146] 613 F. 2d 770 (9th Cir. 1980).
[147] *See* Snyder v. Comm'r, 93 T.C. 529 (1989); Tech. Adv. Memo 873007; Priv. Ltr. Rul. 9117035 (Apr. 26, 1991).
[148] *See* I.R.C. § 2518.
[149] 455 U.S. 305 (1982).

encompasse[d] an indirect transfer, effected by means of a disclaimer, of a contingent future interest in a trust."[150] The Court found that Congress had specifically indicated that the term *transfer*, at least as used in the statutory provisions defining the gift tax, is "used in the broadest and most comprehensive sense."[151] The Court's holding conflicted with the decision of the U.S. Court of Appeals for the Eighth Circuit in *Keinath v. Commissioner*,[152] which applied the prevailing common law rule that the holder of a vested remainder interest subject to divestiture has a reasonable time after the death of the life beneficiary to renounce or disclaim the remainder without tax consequences.[153] In *Jewett*, the Court noted that *Keinath* "emphasized that the holder of the remainder interest did not obtain a right to beneficial ownership and control of the property until the death of the life beneficiary,"[154] and rejected *Keinath*'s reasoning, finding that the disclaimer was not timely and that the property disclaimed was therefore subject to gift tax.[155] The dissent sought to distinguish a disclaimer from a voluntary transfer of property on the basis that a transfer to the disclaimant is incomplete because acceptance has not occurred.[156] In addition, a transferor chooses the recipients of the transfer, but a disclaimant can make no such selection.[157] The dissent's reasoning is inconsistent, however, with the notion that one can make a gift of any interest in property, even if the interest has not yet become possessory.

In Revenue Ruling 81-264, the Service confirmed that a taxable gift can occur by permitting legal rights to expire.[158] The ruling considered the consequences of permitting the statute of limitations to run on the recovery of a loan to a family member and concluded that the lender made a gift to the debtor, who had some financial resources repay the loan.[159] The facts of the ruling are as follows:

> *D* loaned $500,000 to *D*'s child, *A*, and received from *A* a promissory note payable on demand, bearing interest at the market rate. At the time of the transaction, *D* and *A* intended that the note be enforceable. The state statute of limitations on recovery of a demand loan and accrued interest is three years and begins to run on the date of the making of the loan. *D* did not make demand on the note and the state statute of limitations on recovery of the loan and accrued interest ran . . . When the statute ran, *A* had some financial resources.[160]

Revenue Ruling 81-264 states that if the loan is made as part of a prearranged plan under which the lender "intends to forgive or not collect on the note, the note will not be considered valuable consideration and the promisee will have made a gift at the time of the loan to the full extent of the loan."[161] If there is no "prearranged plan, but the promisee later forgives the debt, the promisee will have made a gift at the time of the forgiveness."[162] The amount of the gift will be "the principal amount forgiven and the interest accrued to the date of the forgiveness."[163] General Counsel Memorandum 38,584 states that Revenue Ruling 81-264 based its conclusion on *Estate of Lang v. Commissioner*,[164] which held that the lapse of the statute of limitations on the collection of certain loans made by Mrs. Lang to her son transformed the loans into gifts because it transferred control of the debt to the debtor at the end of the statutory period.[165] Thereafter, the debtor, not the creditor, decides whether and under what terms to repay loaned funds.

[150] *Id*. at 310 (citing Smith v. Shaughnessy, 318 U.S. 176 (1943)).
[151] *Id*. at 309 (internal quotation marks omitted).
[152] 480 F. 2d 57 (8th Cir. 1973), *overruled* by Irvine v. United States, 936 F. 2d 343 (8th Cir. 1991).
[153] *See id*. at 64.
[154] *Jewett*, 455 U.S. at 309 n.6.
[155] *See id*. at 318.
[156] *See id*. at 323 (White, J., dissenting).
[157] *See id*.
[158] *See* Rev. Rul. 81-264, 1981-2 C.B. 185.
[159] *See id*.
[160] *Id*.
[161] *Id*. (citing Rev. Rul. 77-299, 1977-2 C.B. 343).
[162] *Id*.
[163] *Id*. (citing Republic Petroleum Corp. v. U.S., 397 F. Stipp. 900 (E.D. La. 1975), re*v'd on other grounds*, 613 F. 2d 518 (5th Cir. 1980); Treas. Reg. § 25. 2511-1).
[164] 64 T.C. 404 (1975), *aff'd in part, rev'd in part*, 613 F. 2d 770 (9th Cir. 1980).
[165] *See* Gen. Coun. Mem. 38,584 (Dec. 10, 1980) (citing Rev. Rul. 81-264, 1981-2 C.B. 185; Estate of Lang, 64 T.C. at 404).

Affirming the Tax Court's analysis, the U.S. Court of Appeals for the Ninth Circuit cited *Smith v. Shaughnessy* for the proposition that the essence of a taxable gift is the abandonment of control over the property.[166] "That control is transferred by a statutory mechanism rather than an overt donative gesture is not significant."[167] The General Counsel Memorandum acknowledged, however, some circumstances may allow the lender to show that the statute of limitations lapsed in the ordinary course of business based upon the prospects of full recovery.[168]

Similarly, an income beneficiary's failure to exercise the power to make unproductive property productive may constitute a gift to the trust's remainder beneficiaries because this failure reduces the value of the retained income interest and increases the value of the trust corpus.[169]

In *Harris v. Commissioner*,[170] the Court acknowledged that the transfer of property between spouses could qualify as being in the ordinary course of business rather than as the voluntary settlement of marital rights based upon a promise or agreement. Without more, the Court would not have recognized such a voluntary settlement as full and adequate consideration:

> The Treasury Regulations recognize as tax free "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)." This transaction is not "in the ordinary course of business" in any conventional sense. Few transactions between husband and wife ever would be; and those under the aegis of a divorce court are not. But if two partners on dissolution of the firm entered into a transaction of this character or if chancery did it for them, there would seem to be no doubt that the unscrambling of the business interests would satisfy the spirit of the Regulations. No reason is apparent why husband and wife should be under a heavier handicap absent a statute which brings all marital property settlements under the gift tax.[171]

In *Harris*, the property given to the husband greatly exceeded the value of the property received by the wife.[172] By holding that the arrangement was in the ordinary course of business, the Court found that no gift tax was due notwithstanding the substantial inequality of the property transferred between the spouses (the Court decided this case long before enactment of the unlimited marital deduction).[173]

However, the *Harris* holding might have been dependent on court approval of the property division. In Revenue Ruling 68-379, the Service seems to depart from *Harris*.[174] In this ruling, "[a] husband and wife entered into an agreement incident to a legal separation. Pursuant to the agreement, the husband transferred property to the wife in full settlement of her property and support rights."[175] The ruling concluded that the transfer of property under these circumstances constitutes "a taxable gift to the extent the value of the property transferred [exceeds] the value of any support rights surrendered."[176] Although superseded by section 2516,[177] the ruling casts some doubt on the extent to which *Harris* supports an ordinary course of

[166] *See id*. at 773 (citing Smith v. Shaughnessy; 318 U.S. 176, 181 (1943)).
[167] *Id*.
[168] *See* Gen. Coun. Mem. 38,584 (Dec. 10, 1980).
[169] *See* Priv. Ltr. Rul. 9045047 (Aug. 15, 1990); Priv. Ltr. Rul. 9035029 (Aug. 31, 1990); Priv. Ltr. Rul. 9035022 (Aug. 31, 1990) (relying on the reasoning of Dickman v. Comm'r, 465 U.S. 330 (1984)).
[170] 340 U.S. 106 (1950).
[171] *Id*. at 112.
[172] *See id*. at 109.
[173] *See id*. at 112; *see also* Rev. Rul. 68-379, 1968-2 C.B. 414 ("[S]ince support rights are distinguishable from inheritance rights, a surrender of support rights is not a surrender of 'other marital rights' as that phrase is used in the regulations. A release of support rights constitutes a consideration in money or money's worth.").
[174] *See* Rev. Rul. 68-379, 1968-2 C.B. 414.
[175] *Id*. at 415.
[176] *Id.*
[177] *See* I.R.C. § 2516.

business exception in the context of transfers of property interests among family members absent a court approved settlement of a dispute concerning the parties' property rights.[178]

Revenue Ruling 79-327 considers the exercise of a power of appointment over a testamentary trust that gives an individual a lifetime income interest in the trust property with the power to appoint all or part of the trust property during lifetime to one or more children.[179] The ruling concludes that the exercise of the special power of appointment results in a gift, for purposes of section 2511, of the income interest in the underlying relinquished property.[180]

More troubling perhaps is the Service's continued adherence to the view that the relinquishment of a discretionary interest in a trust constitutes a taxable gift. In Private Letter Ruling 200243026, the settlor created an irrevocable trust for the benefit of the settlor's spouse, lineal descendants, and the spouses of those descendants.[181] The trustees had authority to distribute any amounts of net income among the beneficiaries as the disinterested trustee, in his sole discretion, deemed "necessary or appropriate for [the beneficiaries'] care, support, maintenance, education, advancement in life and comfortable living."[182] The settlor's spouse also appears to have had a discretionary interest in trust principal.[183] The spouse was "granted a lifetime power to appoint the principal of the [t]rust to any one or more of a group consisting of [the] settlor's lineal descendants and their spouses."[184] The settlor's spouse also had a testamentary power of appointment among the settlor's lineal descendants.[185] The spouse proposed to exercise his *inter vivos* power of appointment in part to appoint a trust for the benefit of his grandchildren.[186] The trust was otherwise exempt from the GST tax.[187] The Service ruled that although spouse's rights to receive income and principal distributions from the trust were subject to the sole discretion of the disinterested trustee, the relinquishment of those interests would be, under section 2511(a), a taxable gift, the value of which is a question of fact.[188] In addition, because the spouse will have made a taxable gift of his income and principal interests in the trust, he becomes the transferor of the taxable gift's value for purposes of chapter 13.[189] The spouse, therefore, is deemed to have made direct skip transfers to the trusts for grandchildren.[190]

Private Letter Ruling 200243026 cites to Revenue Ruling 75-550 for "the correct method of computing the value of a[n] . . . interest in a trust . . . subject to the discretionary power of the trustee to invade corpus for the benefit of others."[191] Revenue Ruling 75-550 concerns, for purposes of the credit for tax on prior transfers under section 2013, the computation of a decedent's interest in a residuary trust that is subject to the trustee's discretionary power to invade the corpus for the benefit of others.[192] The second decedent had an income interest in the trust.[193] The Service established that the trust anticipated corpus invasions for the children in the amount of $100,000 annually.[194] Accordingly, the Service computed the value of the life estate by taking the anticipated attrition of the corpus into account.[195] Thus, when the valuation problem is establishing the fair market value of the discretionary interest, the anticipated pattern of distribution is

[178] *See also* Rev. Rul. 79-363, 1979-2 C.B. 345 (stating that a transfer for benefit of an adult child constitutes a taxable gift unless spouse relinquished support rights of equal value to obtain the benefit).
[179] *See* Rev. Rul. 79-327, 1979-2 C.B. 342.
[180] *See id*. at 343.
[181] *See* Priv. Ltr. Rul. 200243026 (July 24, 2002).
[182] *Id*.
[183] *See id.*
[184] *Id*.
[185] *See id.*
[186] *See id*.
[187] *See id*.
[188] *See id*.
[189] *See id*.
[190] *See id*.
[191] *Id*. (citing Rev. Rul. 75-550, 1975-2 C.B. 357).
[192] *See* Rev. Rul. 75-550, 1975-2 C.B. 357.
[193] *See id*.
[194] *See id*.
[195] *See id*. at 358-59.

probative.[196] In such a case, limiting language, including language requiring the trustee to take other resources into account, might help to depress the interest's value, although such language may otherwise inhibit flexible administration of the trust and may prohibit decanting to effectuate a reformation.[197]

More recently, in Private Letter Ruling 201122007, the Service again ruled that the taxpayer made a taxable gift of her interest in the portion of the trust principal distributed to the remainder beneficiaries of a trust in which she had a discretionary interest.[198] The trust provided the following:

> [N]et income . . . shall be accumulated and added to the principal and shall not be distributed to any beneficiary except the ultimate beneficiaries of the principal and corpus of the trust at the termination of the trust, unless the trustee shall, in his absolute discretion, determine that the income thereof or some portion thereof should be distributed.[199]

The trust also authorized the trustee to distribute principal for "health, support or maintenance."[200] The taxpayer submitted an affidavit

> affirming that . . . her income and resources [were] sufficient to maintain her current standard of living for the remainder of her lifetime and any foreseeable emergencies; [that] her financial condition prevent[ed] her from receiving any income or principal from the trust pursuant to the terms of the trust; and [that] she . . . received no distributions from the trust . . . and [did] not anticipate any in the future.[201]

The co-trustee submitted an affidavit stating that, under the trust's terms, distributions may only be made to the taxpayer in the case of emergency.[202] The Service ruled favorably that the advancement of principal to the remainder beneficiaries did not cause a loss of GST exempt status.[203] However, the amount of the taxpayer's taxable gift that resulted from the relinquishment of her discretionary interest remained a question of fact on which the Service refused to rule.[204] On the bright side, the Service seemed to accept from the affidavits that the distributions to the taxpayer would be limited to income (apparently not corpus) and only for emergencies and that the value of the taxpayer's interest may be nominal.[205]

Given the foregoing authorities, a beneficial interest in a trust at death—even one that has not yet matured or is subject to divestment—is clearly a state law interest in property that may be subject to estate tax. Similarly, a voluntary transfer of a beneficial interest in a trust, either by surrendering the interest or exercising a power that extinguishes or reduces the interest, is subject to gift tax, even if the interest may have nominal value. The burden of demonstrating the possibly nominal value falls on the taxpayer. The failure to assert legal rights that results in a reduction or elimination of a property right also can create a taxable gift.

This leads to the question of when changes to an existing trust under the authority of state common or statutory law will have transfer tax consequences. The answer depends in part on the nature and extent of the property interest held through the trust arrangement and in part on the extent of the beneficiary's legal right to object to the proposed action. The answer might also depend on whether the court construes affirmative consent or the failure to object to the action taken as occurring in the ordinary course of business and thus excepted from the application of gift tax.

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196 *See id*.
197 *See id*. at 358; FL. STAT.. § 736.04117 (West 2010) (requiring a trustee to have absolute discretion to invade a trust's principal in order to have the authority to decant).
198 *See* Priv. Ltr. Rul. 201122007 (Jun. 3, 2011).
199 *Id*. at 1.
200 *Id*. at 2.
201 *Id*.
202 *See id*.
203 *See id*. at 3.
204 *See id*.
205 *See id*. at 4.

We begin with a review of the various methods by which one can legally change an existing trust.

## IX. Rescission, Reformation, Modification, and Termination

### A. What is Permitted?

#### 1. Background[206]

The polestar of administering trust instruments is donor's intent. Under Restatement (Third) of Property, the controlling consideration in determining the meaning of a donative document is the donor's intention. The donor's intention is given effect to the maximum extent allowed by law.[207] An ambiguity to which no rule of construction applies is resolved by construing the document in accordance with the donor's intention to the extent that intention is established by a preponderance of the evidence.[208] When construction does not permit the document to be interpreted consistently with donor's intention, the need for reformation arises.

The most straightforward need for reformation occurs when the donative document although unambiguous but does not conform to the donor's intention. In that case, the document may be reformed to conform to the donor's intention, if it is established by clear and convincing evidence that there was a mistake of fact or law, whether in expression or inducement, and what the donor's intention was.[209]

The concept of modification, reformation, and termination of trusts by the beneficiaries is not unique to American law. English law permitted beneficiaries to terminate a trust at any time upon the consent of all beneficiaries, provided all beneficiaries were adult and *sui juris*.[210] By the 1950s, Parliament enacted the Variation of Trusts Act of 1958, which expressly permitted courts to modify or terminate trusts.[211] Parliament enacted this legislation to allow beneficiaries to avoid adverse tax consequences resulting from the terms of existing irrevocable trusts.[212] English law apparently treated the trust estate as belonging to the beneficiaries, particularly after the settlor's

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[206] This portion of the article based in part on the analysis set forth in JESSE DUKEMINIER, ROBERT H. SITKOFF & JAMES LINDOREN, WILLS, TRUSTS AND ESTATES 641(8th ed. 2009).

[207] Restatement (Third) of Property (Wills & Don. Trans.) § 10.1 (2003). "Meaning" in this context will be determined by a construction of the document and is controlled by the donor's intention. In general, American law does not grant courts general authority to question the wisdom, fairness or reasonableness of the donor's decisions about the disposition of the donor's property. However, if the effect of the donor's intention violates the law because it impairs spousal rights, places unreasonable restraints on alienation or marriage, promotes separation or divorce, requires impermissible racial or other categoric restrictions, encourages illegal activity or violates the rule against perpetuities, the provisions will not be enforced. *See id.* at *Comment c.*

[208] *Id.* at § 11.2. Note that there must be a valid document in order for a reformation to be permissible. *See* Kelly v. Lindenau, 223 So.3d 1074 (FLA. 2d DCA 2017).

[209] *Id.* at § 12.1. Note that there must be a document in order for the remedy of reformation to apply and the mistake of the donor must be contemporaneous with the execution of the document. Reformation relates back and operates to alter the text of the document as of the date of execution. Accordingly, the remedy of reformation does not apply to changes in desire after the fact or a mistake that does not relate to the facts as they existed when the document was executed. *Id.* at *Comment f. See, e.g.*, Morey v. Everbank, 93 So. 2d 482 (1st DCA 2012) (reformation sought to required life insurance proceeds to be placed directly into a subtrust for the decedent's children; court held reformation was not available to modify the terms of a trust to effectuate what the settlor would have done differently had he foreseen a change of circumstances that occurred after the instruments were executed); In re Matthew Larson Trust Agreement, 2013 ND 85 (2013) (the appellate court reversed the trial court holding that the settlors' ignorance of the law that heirs "of the half blood" were treated as if they were "of the whole blood" was a basis for reformation because clear and convincing evidence existed that a mistake of law was made in drafting the trusts that affected the settlors' intent and the trust terms).

[210] *See* Saunders v. Vautier, (1841) 49 Eng. Rep. 282 (P.C.) 282 (appeal taken from S.C.).

[211] *See* Variation of Trusts Act, 1958, 6 & 7 Eliz. 2, c. 53, § 1 (Eng.).

[212] *See* DUKEMINIER, ET AL., *supra* note 141.

death.[213] This view repudiated the settlor's continuing control over the disposition of the assets held in trust.[214]

2. Claflin Doctrine

In contrast, the traditional rule in the United States disallows trust modification or termination prior to the time required by its governing instrument merely upon the beneficiaries' application. In *Claflin v. Claflin*,[215] the court held termination or modification of an irrevocable trust to be impermissible if it would be contrary to a material purpose of the settlor. The *Claflin* standard requires that beneficiaries not do violence to the settlor's intent. Accordingly, respect for the settlor's intent prevails unless that intent ran contrary to some rule of law or public policy.[216] The *Claflin* court declined to terminate a trust prior to its stated age termination date.[217] The court opined:

> The existing situation is one the testator manifestly had in mind, and made provision for. The strict execution of the trust has not become impossible; the restriction upon plaintiff's possession and control is, we think, one that the testator had a right to make; other provisions for the plaintiff are contained in the will, apparently sufficient for his support; and we see no good reason why the intention of the testator should not be carried out.[218]

The court stated that "[i]t cannot be said that [the] restrictions on the [beneficiary's] possession and control of the property [were] altogether useless, for there is not the same danger that [the beneficiary would] spend the property while it [was] in the hands of the trustees . . . ."[219]

3. Claflin and Terminating a Trust

The *Claflin* doctrine continues to have significant impact not only on legislation dealing with modification, reformation, and termination of trusts, but also in court decisions dealing with requests for these actions. In *In re Trust Under Last Will & Testament of Weitzel*,[220] a mother created a trust for her daughter for the daughter's lifetime, remainder to the mother's two grandsons. The trust required the corporate trustee to pay income to the daughter or her guardian or apply the income for her benefit.[221] The trustee also had discretion to pay principal for the daughter's proper care, support, and maintenance.[222] The trust contained a spendthrift clause prohibiting the beneficiary from selling, assigning, transferring, or encumbering her interest.[223] The daughter and the two grandsons filed a petition to terminate the trust, alleging that financial problems of the daughter and her husband caused the formation of the trust and that, because those concerns had been resolved, the trust had no continuing purpose.[224] The Iowa statute provided that the court may terminate an irrevocable trust upon the consent of all the beneficiaries if continuance of the trust on the same or different terms is unnecessary to carry out a material purpose.[225] The court cited *Restatement (Third) of Trusts* for the proposition that because a trust agreement might contain a spendthrift clause as a matter of routine, a spendthrift clause alone is insufficient to create or establish, or create a presumption of, a material purpose that would

[213] *See id*.
[214] *See id*.
[215] 20 N.E. 454 (Mass. 1889).
[216] *See id*. at 456.
[217] *See id*.
[218] *Id*.
[219] *Id*.
[220] No. 09-0447, 2009 WL 4842807 (Iowa Ct. App. Dec. 17, 2009).
[221] *See id*. at *1.
[222] *See id*.
[223] *See id*.
[224] *See id*. at *2.
[225] *See id*. at *4.

prevent a trust's termination.[226] The court instead focused on a provision expressing a wish that certain property not be sold, as well as on the fact that the decedent executed the will many years after the resolution of the beneficiary's financial problems and still provided for a trust.[227] The court quoted an observation from a prior Iowa case:

> [T]rusts are usually created for the purpose of withholding from the beneficiaries or other interested parties the control and disposition of the principal of the fund for reasons which appear sufficient to the trustor, and they are not usually regarded with satisfaction by the persons who are deprived of the possession of the estate. This, however, furnishes no ground for disregarding the conditions on which the bounty is to be bestowed, nor for refusing to carry out the expressed design of the party creating the trust.[228]

Accordingly, the court denied the petition for termination.

In *Estate of Brown*,[229] the trustee of a testamentary trust appealed a trial court's order granting the lifetime and residual beneficiaries' petition to terminate a testamentary trust and distribute the proceeds to the life tenants. The primary issue raised was whether the trust continued to accomplish a material purpose.[230] The trust's primary purpose appeared to be providing for the education of the life tenant.[231] However, the trust also provided that once that purpose had been accomplished, the trust would continue to use income and principal as necessary "*for the care, maintenance and welfare of [the beneficiary and his wife] so that they may live in the style and manner to which they are accustomed, for and during the remainder of their natural lives*."[232]

The court first held that the trust was neither a support trust nor a spendthrift trust; therefore, those were not unaccomplished material purposes preventing termination.[233] A support trust requires the trustee to use income and principal only to the extent necessary for support.[234] The trust was also not a spendthrift trust, even though the interests in the trust were not transferable.[235] Nevertheless, the court ruled that the trust had two material purposes: to provide for education and to assure life-long income for the beneficiaries through the trustee's management and discretion.[236] The language of the trust did more than create successive gifts; it provided for "the care, maintenance and welfare of [the lifetime beneficiaries] so that they may live in the style and manner to which they are accustomed, *for and during the remainder of their natural lives*."[237] The court held that the italicized language indicated a second and material purpose—providing a life-long income—that terminating the trust would defeat.[238]

*Restatement (Third) of Trusts* , part 5, Chapter 13, Introductory Note acknowledges the trend towards longer duration trusts and increased complexity in estate planning, and the appropriateness of a concomitant liberalization of the traditional rules concerning revocation, termination and modification to address the practical consideration that courts increasing encounter such as "apparent oversight and human error". The Introductory Note also cites the growing recognition that trusts should serve the beneficiaries' best interests and that greater

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[226] *See id*. at *5 (citing RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. e (2003)).
[227] *See id*.
[228] *Id*. at *6 (quoting Hopp v. Rain, 88 N.W. 2d 39, 45 (Iowa 1958) (internal quotation marks omitted)).
[229] 528 A. 2d 752 (Vt. 1987).
[230] *See id*. at 753.
[231] *See id*.
[232] *Id*. at 754 (emphasis in original).
[233] *See id*.
[234] *See id*.
[235] *See id*
[236] *See id*.
[237] *Id*. (emphasis in original omitted).
[238] *See id*.

flexibility is more likely to aid than to undermine the settlor's objectives as additional reasons to liberalize the rules.

*Restatement (Third) of Trusts* section 64 articulates the general rule that "the trustee or beneficiaries of a trust have only such power to terminate the trust or to change its terms as is granted by the terms of the trust."[239] If a third party has a power by the terms of a trust to terminate or modify the trust, the law presumes the third party holds the power in a fiduciary capacity.[240] Section 65 of *Restatement (Third) of Trusts* provides that "if all the beneficiaries of an irrevocable trust consent, they can compel the termination or modification of the trust."[241] However, if the modification or termination would be inconsistent with a material purpose of the trust, then the modification or termination requires the settlor's consent or, if the settlor is deceased, court approval upon a determination that the reason for termination or modification outweighs the material purpose.[242]

Comment *b* to section 65 of *Restatement (Third) of Trusts* confirms that the term *beneficiary consent* means the consent of all potential beneficiaries, even those who lack capacity.[243] Subsection (1) and comment *b* require the consent of all holders of powers of appointment, as well as the takers in default, except in the case of a presently exercisable general power of appointment.[244] Comment *b* acknowledges that consent may not be obtainable as a practical matter in many situations, although guardians ad litem, court appointed representatives, or other beneficiaries who are representatives under the doctrine of virtual representation may be able to provide consent.[245] Comment *c* states that consent by representatives may present issues when such consent diminishes the represented beneficiaries' interests, such as with a termination.[246]

The material purpose restriction is interesting because it survives in many modern statutes. The material purpose restriction does not apply if the settlor is alive and able to waive it.[247] But the drafters intended the restriction to limit modification or termination by act of the beneficiaries "out of respect for serious objectives that appear to have motivated the settlor in creating the trust."[248] Comment *d* acknowledges that, under the *Claflin* doctrine, one cannot always easily distinguish between a material purpose and other specific intentions of the settlor that are deemed to be less important.[249]

> [T]he identification and weighing of purposes under this Section frequently involve a relatively subjective process of interpretation and application of judgment to a particular situation, much as purposes or underlying objectives of settlors in other respects are often left to be inferred from specific terms of a trust, the nature of the various interests created, and the circumstances surrounding the creation of the trust."[250]

Comment *d* also states that "[m]aterial purposes are not readily to be inferred."[251] Instead, a finding of a material purpose "requires some showing of a particular concern or objective on the

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[239] RESTATEMENT (THIRD) OF TRUSTS § 64 (2003).
[240] *See id*.
[241] *Id*. § 65.
[242] *See id*.
[243] *See id*. cmt. b.
[244] *See id*. § 65(1) & cmt. b.
[245] *See id*. § 65 cmt. b.
[246] *See id*. cmt. c. But *see id*. reporter's notes, cmts. b & c ("A representative's consent to a proposed modification or termination may also be facilitated: (i) by a life-insurance arrangement to cover the risk of a primary beneficiary's . . . premature death . . .; or (ii) by an indemnification agreement from the adult or primary remainder beneficiaries.").
[247] *See id*. § 65 cmt. d.
[248] *Id*.
[249] *See id*.; discussion supra Part III.A.2.
[250] RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. d (2003).
[251] *Id*.

part of the settlor, such as concern with regard to a beneficiary's management skills, judgment, or level of maturity."[252] A trustee's authority to terminate a trust early may indicate that retaining property in trust was not a material purpose and thus permit beneficiaries to consent to a termination earlier than the express terms of the trust otherwise provide. Comment *e* concludes that restraints on alienation—such as a spendthrift clause—or a trust that provides for support or other discretionary benefits may indicate a protective material purpose, inconsistent with permitting the beneficiaries to terminate the trust.[253] In some states, a trust is automatically spendthrift unless the settlor provides otherwise.[254] Comment *e* acknowledges that a spendthrift clause alone is insufficient to establish a material purpose to continue property in trust.[255] In contrast, a trust with broad discretionary powers may justify a finding that a material purpose of the trust was "to secure the ongoing, flexible and (possibly expert) judgment of the trustee regarding the amount, timing, and recipients of distributions over the duration of the trust."[256]

A modification that does not violate a material purpose of the trust may be easier to achieve than a termination.[257] In a modification, the focus is on the particular amendment sought.[258] Comment *h* confirms that a court may terminate or modify a trust to settle a bona fide dispute, notwithstanding that the termination or modification is inconsistent with a material purpose of the trust.[259]

The legacy of the *Claflin* doctrine may indicate greater potential tax consequences to beneficiaries who consent or fail to object to a termination, modification, or rescission of an irrevocable trust. The reason for these consequences is that consent or failure to object may constitute a waiver of valid rights under state law to avoid the relief requested. If such a waiver diminishes or eliminates a beneficial interest in an irrevocable trust, that reduction may be a taxable gift. The inquiry would be whether one construes the consent or failure to object as in the ordinary course of business—an arm's length transaction free of donative intent. Alternatively, perhaps one can successfully argue that the beneficial interest surrendered is of such nominal value that no gift tax would be imposed.

4. Equitable Deviation

The *Claflin* doctrine on modification and termination is distinct from the doctrine of equitable deviation, which allows a court, upon application by the beneficiaries, to deviate from the administrative terms of a trust if continued compliance, in light of changed circumstances unanticipated by the settlor, would defeat or substantially impair achieving the purposes of the trust.[260] Depending on state law, deviation might be difficult to achieve because a change in circumstances that makes deviation more advantageous to the beneficiaries may be held insufficient for relief, even if the change is relatively dramatic, such as the unanticipated special-needs status of a beneficiary.[261]

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[252] *Id*.
[253] See *id*. cmt. e.
[254] *See, e.g*., Regan v. Ross, 691 F. 2d 81, 86 n.14 (2d Cir. 1982) (noting that "under New York law all express trusts are presumed to be spendthrift unless the settlor expressly provides otherwise").
[255] *See* RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. e (2003).
[256] *Id*.
[257] *See id*. cmt. f.
[258] *See id*.
[259] *See id*. cmt. h.
[260] *See* John K. Eason, *Private Motive and Perpetual Conditions in Charitable Naming Gifts: When Good Names Go Bad*, 38 U.C. DAVIS L. REV. 375, 437-38 (2005).
[261] *See, e.g*., Appeal of Harrell, 801 P. 2d 852 (Or. Ct. App. 1990) (denying petition to modify trust under which special needs beneficiary would receive corpus outright upon the death of a senior generation of income beneficiaries because modification would defeat the special needs beneficiary's access to government benefits); *but see* In re Riddell, 157 P. 3d 888, 892 (Wash. Ct. App. 2007) (permitting modification to create a special needs trust for a mentally ill beneficiary because one of the trust's purposes was to provide for education, support, maintenance, and medical care and because federal law invited the creation of trusts of this kind).

One of the most notable cases on equitable deviation is *In re Pulitzer*[262] in which the decedent's will precluded the sale of shares of stock in a corporation publishing World newspapers. After many years of losses, the trustees petitioned the court for approval of a sale of the shares. The court held that it had authority to approve the sale, thereby deviating from the terms of the trust, because the trust estate was in jeopardy. *Pulitzer* provided the standard for equitable deviation for many years, and was limited to administrative provisions. However, over time, that standard proved too narrow, providing an inadequate remedy to protect the interests of the beneficiaries.

Accordingly, the standard for equitable deviation has relaxed. A court under a more modern standard may modify an administrative or distributive trust provision or direct or permit a trustee to deviate from an administrative or distributive provision if, because of changed circumstances not anticipated by the settlor, the modification or deviation will further the trust's purposes.[263]

Section 66 of *Restatement (Third) of Trusts* sets forth the modern doctrine of equitable deviation: "[a] court may modify an administrative or distributive provision of a trust, or direct or permit the trustee to deviate from an administrative or distributive provision, if because of circumstances not anticipated by the settlor the modification or deviation will further the purposes of the trust."[264] Section 66 imposes on the trustee an affirmative duty to seek judicial intervention regarding administrative provisions if circumstances arise justifying the relief and the trustee knows or should know that the circumstances could potentially cause substantial harm to the trust or its beneficiaries.[265] The reporter's note observes that the rule on equitable deviation in *Restatement (Second) of Trusts* section 167(1) was substantially more restrictive, permitting deviation only if the circumstances were unknown to and unanticipated by the settlor and compliance with the trust's terms would defeat or substantially impair the accomplishment of the trust's purposes.[266]

Because equitable deviation permits changes that affect only the administration of the trust, and not the beneficial interests, it should have limited tax risk for the beneficiaries.[267]

B. Modern View of Changing Irrevocable Trusts Under the Uniform Trust Code

Consistent with the liberalization reflected in the Restatement, the Uniform Trust Code ("UTC") contains six separate provisions dealing with the reformation, modification, or termination of a trust, all of which appear in Article 4.[268] Section 411 of the UTC deals with modification or termination of a noncharitable irrevocable trust by consent. If the settlor consents to the modification or termination, the court may approve it even if it is inconsistent with a material purpose of the trust. Otherwise, the requirement that the modification or termination not be inconsistent with a material purpose of the trust is preserved. As in the Restatement, the Comments to Section 411 state that in order for a purpose to be material, the purpose remaining to be performed must be of some significance. Accordingly, it requires some showing of a particular concern or objective on the part of the settlor. Section 412 of the UTC deals with judicial modification or termination because of unanticipated circumstances. Section 413 deals with cy pres. Section 414 deals with modification or termination of an uneconomic trust. Section 415 deals with

[262] 249 N.Y.S. 87 (Sur. 2941, *aff'd*, 260 N.Y.S. 975 (App. Div. 1932).
[263] *See* Niemann v. Vaughn Cmty. Church, 113 P. 3d 463 (Wash. 2005) (permitting modification to trust where changed, unanticipated circumstances warranted equitable deviation from the trust's terms).
[264] RESTATEMENT (THIRD) OF TRUSTS § 66(1) (2003).
[265] *See id*. § 66(2).
[266] *See id*. § 66 reporter's notes; see also RESTATEMENT (THIRD) OF PROPERTY (WILLS & OTHER DONATIVE TRANSFERS) § 12.2 (2003) (permitting one to modify a donative document to achieve the donor's tax objectives, provided the modification does not violate the donor's probable intention).
[267] *See*, *e.g.*, Treas. Reg. § 26.2601-1(b)(4) (permitting modifications to the administrative provisions of a trust without adverse GST tax consequences).
[268] *See* UNIF. TRUST CODE art. 4 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).

reformation to correct mistakes. Section 416 deals with modification to achieve a settlor's tax objectives.[269]

Some states have additional provisions. For example, Florida's version of the UTC, the Florida Trust Code ("FTC"), has nine provisions that deal with changing an existing trust's terms.[270] The Florida provisions are more liberal than the UTC's and therefore raise additional issues.[271]

This subpart discusses the provisions of the FTC for illustrative purposes and to show the potential scope of state law authority for changes to trusts. If one reforms, modifies, or terminates a trust for tax purposes pursuant to a state statute that provides express authority to do so, that statute will greatly assist the defense of one's action.

Although the heading to section 736.04113 of the FTC states that it permits judicial modification of an irrevocable trust when modification is not inconsistent with the settlor's purposes, that restriction is not repeated in the statute itself. The trustee or any qualified beneficiary may initiate a court application.[272] The statute permits modification upon satisfaction of one of the following three conditions:

> [t]he purposes of the trust have been fulfilled or have become illegal, impossible, wasteful or impracticable to fulfill; . . . [b]ecause of circumstances not anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust; or . . . [a] material purpose of the trust no longer exists.[273]

*Restatement (Third) of Trusts* deviates from the FTC by permitting modification even if it conflicts with a material purpose of the trust, provided "the reason(s) for modification outweigh the material purpose."[274]

FTC section 736.04113 does not expressly require that the settlor be a party to a proceeding for modification, and one need not obtain the settlor's consent even if the settlor is living.[275] The court must "consider the terms and purposes of the trust, the facts and circumstances surrounding [its] creation . . ., and extrinsic evidence relevant to the proposed modification."[276] If the application satisfies one of the three conditions and upon consideration of the foregoing factors, the court may amend or change the trust's terms (including the administrative and distributive provisions), terminate the trust in whole or in part, direct or permit the trustee to do acts that the terms of the trust either prohibit or do not authorize, or prohibit the trustee from acting as the trust permits or requires.[277] The requirements of section 736.04113 appear to be the most restrictive of all the FTC modification provisions, and the section adheres fairly strictly to the *Claflin* doctrine, which permits modification only if not in derogation of a trust's material purpose.[278] The trust instrument may not waive the provisions of section 736.04113.[279]

Section 736.04113 differs from section 412 of the UTC, which permits judicial modification or termination of a trust "if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust."[280] Under the UTC, one must consider all of the trust's purposes, not just material purposes. The UTC drafters intended the terms of section 412 to codify the doctrine of equitable

[269] *See, e.g.*, Matter of Oskar Brecher (2017 NY Slip. Op. 30022(U) (SURR. CT. NY CTY 2017) (court permitted reformation of a decedent's will containing a pecuniary formula bequest drafted prior to the change in the New York estate tax providing for an independent state estate tax exclusion).
[270] *See* FLA. STAT. ANN. §§ 736.04113 to 0417 (West 2017).
[271] *See id*.
[272] *See id*. § 736.04113(1).
[273] *Id*. § 736.04113(1)(a)—(c).
[274] RESTATEMENT (THIRD) OF TRUSTS § 65 (2003).
[275] *See* FLA. STAT. ANN. § 736.04113.
[276] *Id*. § 736.04113(3)(a).
[277] *See id*. at § 736.04113(2)(a)—(d).
[278] *See id*. § 736.04113; discussion *supra* Part 111.A.2.
[279] *See* FLA. STAT. ANN. § 736.0105(2)(j).
[280] UNIF. TRUST CODE § 412 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).

deviation.[281] Unlike *Restatement (Third) of Trusts*, the UTC does not impose a duty on the trustee to petition the court if the trustee is aware of circumstances justifying a judicial modification.[282] In other words, *Restatement (Third) of Trusts* imposes on a trustee an affirmative duty to seek modification in appropriate circumstances.[283] This duty seems to place an unreasonable and unnecessary burden on the trustee; the UTC is more balanced in allowing a trustee to live by the trust's terms as expressed by the settlor without having continuously to question the appropriateness of those terms. The UTC permits modification if the petitioner can show either that the modification conforms with settlor's intent[284] or—in the case of a modification to the trust's administrative provisions—that continuing the trust under existing terms would be impracticable or wasteful.[285] The FTC provision is broader, essentially combining the *Claflin* doctrine with the doctrine of equitable deviation.

In *Peck v. Peck*,[286] the trustee objected to the application by the settlor/grantor for termination of a trust under FTC section 736.04113 on the ground that the trust's purposes remained unfulfilled. The court recognized that the settlor created the trust in part to avoid unwise dissipation of her assets. The remainder beneficiaries of the trust consented to its termination. The court reviewed *Preston v. City National Bank of Miami*,[287] wherein the court recognized that the terms of a trust may be modified if the settlor and all the beneficiaries consent, the power being derivative of the power a settlor and all the beneficiaries have to terminate a trust. Accordingly, the court permitted termination of the trust, even though the settlor's father contributed substantial property to the trust by his will.[288]

The court's ruling in *Peck*, is troubling for at least two reasons. First, it seems that for purposes of analyzing whose consent was needed to terminate the trust, the settlor's father was in fact a settlor of the trust whose consent should have been required. Although the daughter prepared the trust instrument as settlor, a settlor of a trust for most purposes includes any person who makes a gratuitous transfer of property to the trust. Moreover, the holding in *Peck* squarely raises the issue of whether the rule in *Helvering v. Helmholtz,*[289] that a power to terminate a trust with the consent of all the beneficiaries does not cause estate tax inclusion under section 2038 (dealing with the power to alter, amend or revoke a trust), extends to section 2036 (dealing with the right to determine the disposition of trust income). It is possible that the proper construction should be that the settlor's right to control the income only by obtaining the consent of all beneficiaries is sufficiently speculative and contingent so as not to rise to the level of a retained interest.[290] Nonetheless, section 2036 does not expressly create an exception for a right that is exercisable only with the consent of adverse parties.

FTC section 736.04115 permits judicial modification of a trust where, modification is in the best interests of the beneficiaries.[291] No similar UTC provision exists. The section allows either a trustee or any qualified beneficiary to apply to the court for relief.[292] This provision solves the problem created by *Claflin*'s prohibition on trust modification because rather than looking at the material purposes of the trust as defined by the settlor, the provision looks at the best interests of the beneficiaries. Thus under FTC, it

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[281] *See id*.
[282] *See id*.
[283] *See* RESTATEMENT (THIRD) OF TRUSTS § 66 (2003).
[284] *See, e.g.*, Kranther v. Covey, 2013 WL 1736595 (Court of Appeal, Second District, Division 4, California (2013) (permitting a trust to be modified to preserve or serve the original intentions of the trustor).
[285] UNIT. TRUST CODE § 412, 7C U.L.A. 507.
[286] 133 So. 3d 587 (Fla. 2d DCA 2014).
[287] 294 So. 2d 11 (Fla. 3d DCA 1974).
[288] *Compare* Purcella v. Olive Kathryn Purcella Trust, 325 P.3d 987 (AK 2014) (settlor's petition for termination of an irrevocable trust established for her own protection was denied because the trust was consistent with the settlor's intent, no unanticipated circumstances had arisen to warrant reformation, termination or modification based upon settlor's consent was not permissible because the remainder beneficiaries did not consent, and the trust was not the produce of undue influence) and In re Ethel R. Peierls Charitable Lead Unitrust, 59 A.3d 464 (DE 2012) (convenience is not a valid ground for departing from the settlor's intent).
[289] 296 U.S. 93 (1935).
[290] *See* U.S. v. Byrum, 92 S.Ct. 2382 (1972).
[291] *See* FLA. STAT. ANN. § 736.04115 (West 2010).
[292] *See id*. § 736.04115(1).

would seem one could modify the trust to include special needs provisions, for example, if one of the beneficiaries were to become disabled. The court must "exercise discretion in a manner that conforms to the extent possible with the intent of the settlor, taking into account the current circumstances and best interests of the beneficiaries."[293] The court must a "consider the terms and purposes of the trust, the facts and circumstances surrounding the creation of the trust, and extrinsic evidence relevant tot proposed modification."[294]

Section 736.04115 does not apply to a trust created prior to January 2001.[295] It also does not apply to a trust created after December 31, 2000, if the trust does not take advantage of Florida's 360-year rule against perpetuities and prohibits judicial modification.[296] Thus, if a trust takes advantage the 360-year rule against perpetuities, a provision prohibiting judicial modification when modification is in the best interests of the beneficiaries likely would be unenforceable. This leaves open the question of whether one may have a trust with a 360-year rule against perpetuities if one prohibits judicial modification under other provisions of the FTC but not under section 736.04115. The ability to prohibit judicial modification so as to avoid the application of FTC section 736.04115 appears absolute and does not expressly take into account that section 736.04113 (permitting judicial modification when modification is not inconsistent with the settlor's purpose) is a mandatory provision[297] such that a settlor cannot entirely preclude judicial modification of a trust. Although section 736.04115 appears to permit a settlor to lock beneficiaries into the terms of a trust that uses a common law rule against perpetuities without any opportunity to apply to court for a deviation, the Florida legislature appears to have failed sufficiently to harmonize section 736.04115 with the other modification provisions that it added.

Section 736.04117 is Florida's decanting statute and permits a trustee to invade the principal of a discretionary trust in favor of another trust, provided the second trust does not add beneficiaries; reduce any fixed income, annuity, or unitrust interest; or destroy any provisions that permitted the first trust to qualify for a marital or charitable deduction.[298] The trustee's authority to make principal distributions in the first trust must be "absolute" as defined in the statute.[299] The invasion in favor of another trust under section 736.04117 requires prior notice to qualified beneficiaries but does not require their consent.[300] Beneficiaries have the right to object to the trustee's exercise of the power to invade in favor of another trust in the same way that they can object to other exercises of discretion by the trustee.[301] Section 736.04117 does not abrogate the opportunity to decant under *Phipps v. Palm Beach Trust Co.*,[302] which does not require advance notice to qualified beneficiaries.

FTC section 736.0412 permits nonjudicial modification of an irrevocable trust, as provided in section 736.04113, after the settlor's death and "upon the unanimous agreement of the trustee and all qualified beneficiaries."[303] FTC section 736.0412 is somewhat similar to, but different from UTC section 111. Section 736.0412 allows broader modification. However, the UTC does not require trustee consent.[304]

Section 736.0410(2) permits any beneficiary to commence a judicial proceeding for review of a proposed nonjudicial modification.[305] However, a nonjudicial modification apparently does not require notice to all

[293] *Id*. § 736.04115(2)(a).
[294] *Id*. § 736.04115(2)(b).
[295] *See id*. § 736.04115(3).
[296] *See id.*
[297] *See id*. §§ 736.04113, 736.0105(2)(j).
[298] *See* § 736.04117(1)(a)(1)-(3).
[299] *See id*. § 736.04117(b).
[300] *See id* § 736.04117(b)(4).
[301] *See id.*
[302] 196 So. 299 (Fla. 1940).
[303] FLA. STAT. ANN. § 736.0412.
[304] *See* UNIF. TRUST CODE § 411 (amended 2004), 7C U.L.A. 498-99 (2006).
[305] *Cf. id*. § 111, 7C U.L.A. 450 (allowing any "interested person" to ask for judicial approval).

beneficiaries, nor does section 736.0410(2) appear to provide relief if the modification already has taken effect.[306] As explained in the comments to UTC section 103:

> The qualified beneficiaries consist of the beneficiaries currently eligible to receive a distribution from the trust together with those who might be termed the first-line remaindermen. These are the beneficiaries who would become eligible to receive distributions were the event triggering the termination of a beneficiary's interest or of the trust itself to occur on the date in question. Such a terminating event will typically include the death or deaths of the beneficiaries currently eligible to receive the income. Should a qualified beneficiary be a minor, incapacitated, or unknown, or a beneficiary whose identity or location is not reasonably ascertainable, the representation and virtual representation principles of Article 3 may be employed, including the possible appointment by the court of a representative to represent the beneficiary's interest.[307]

Section 736.0412 allows modifications permitted by section 736.04113(2). The modifications that section 736.04113(2) permits include amending or changing the terms of the trust, "including the terms governing distribution of the trust income or principal or the terms governing administration of the trust"; terminating the trust in whole or in part; directing or permitting the trustee to "do acts not authorized or that are prohibited by the terms of the trust"; or prohibiting "the trustee from performing acts that are permitted or required by the terms of the trust."[308] Section 736.0412 does not apply to a trust created prior to January 1, 2001; to a trust for which a charitable deduction was allowed until the termination of all charitable interests; or to any trust created after December 31, 2000, if the trust must vest under the old rule against perpetuities (before its expansion to 360 years), unless the trust expressly authorizes nonjudicial modification.[309] A spendthrift clause does not preclude nonjudicial modification.[310]

Section 736.0412 apparently assumes that a modification always involves the consent of adverse parties so that under no circumstance would the beneficiaries be deemed to hold a general power of appointment. One might query whether that would be true for every trust to which the provision might apply, and careful drafting might be in order. That only qualified beneficiaries and the trustee (who might be nonadverse) must consent to a proposed modification or termination might create concerns for a settlor establishing a single beneficiary trust destined to terminate in favor of its beneficiary at a stated age. One also could question whether the law would deem the current beneficiary to be the only qualified beneficiary, particularly should that beneficiary also hold a power of appointment. In addition, Treasury Regulation section 20.2041-3(c)(2) provides that in the case of joint powers, "a coholder of the power has no adverse interest merely because of his joint possession of the power nor merely because he is a permissible appointee under a power."[311] Instead, joint holders of a power will be considered adverse only if, upon the death of a coholder of the power, the surviving coholders succeed to the power so that delaying the exercise of the power in favor of the deceased coholder would enhance the surviving coholder's or coholders' interest.[312] This would not happen in a typical trust where the beneficiary's interest normally succeeds to his descendants at death rather than inuring to the surviving current beneficiaries.

For example, suppose that a trust permits distributions to *A*, *B*, and *C* and terminates as to all three beneficiaries equally on a stated date, but if any beneficiary does not survive, that beneficiary's share passes to his descendants. The interests of *A*, *B*, and *C* would not be adverse under the regulation, and if *A*, *B*, and *C* could terminate the trust in their own favor, *A*, *B*, and *C* would each be deemed to hold a general power of appointment over one-third of the trust.

In addition, the provision prohibiting nonjudicial modification of any trust for which a charitable deduction is allowed or allowable under the Code seems troubling, in that it would appear to cover any trust that

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[306] *See* FLA. STAT. ANN. §§ 736.0412, 736.0410(2).
[307] UNIF. TRUST CODE § 103 cmt. (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).
[308] FLA, STAT. ANN. § 736.04113(2)(a), (c), (d).
[309] *See id*. § 736.0412(4)(a)—(c).
[310] *See id*. § 736.0412(2).
[311] Treas. Reg. § 20. 2041-3(c)(2).
[312] *See id*.

permits distributions to charity, even if no charitable deduction was permitted to the settlor upon creation of the trust.

Section 736.0814 would not save the situation. Section 736.0814 addresses the powers of a trustee who is also a beneficiary.[313] In that case, the section limits a power to make discretionary distributions to health, education, maintenance, and support as described in section 2041.[314] The provision seems exclusively to address a trustee's discretionary distribution powers. It is not clear that the restriction would apply to an authority granted to the beneficiary himself, rather than in his capacity as a trustee.

FTC section 736.0414 permits termination of a trust by the trustee upon notice to the qualified beneficiaries if the total value of the trust property is less than $50,000 and the trustee concludes the value of the trust property is insufficient to justify the cost of administration.[315] "Upon application of a trustee or any qualified beneficiary, the court may modify or terminate a trust or remove the trustee and appoint a different trustee if the court determines that the value of the trust property is insufficient to justify the cost of administration."[316] The court also may modify or terminate an uneconomic trust, even if the trust is larger than $50,000.[317] Upon termination, the trustee must distribute the trust property in a manner consistent with the purposes of the trust.[318] The comments to UTC section 414 suggest the trustee typically would make the distribution to the qualified beneficiaries in proportion to their actuarial interests.[319] The FTC added a provision to the UTC language that permits a trustee to "enter into agreements or make such other provisions that the trustee deems necessary or appropriate to protect the interests of the beneficiaries and the trustee and to carry out the intent and purposes of the trust."[320] Note that although courts might construe an easement for conservation purposes as a trust, the court may not terminate such an easement under this provision because courts assume that most creators would wish the easements to continue even if the value were relatively low.[321]

Under section 736.0413, the settlor, a trustee, or any qualified beneficiary may commence a cy pres proceeding in connection with a charitable trust if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful (UTC section 413 is similar in effect).[322] The trustee must apply or distribute trust property, in whole or in part, in a manner consistent with the settlor's charitable purposes.[323]

Similar to UTC section 415, section 736.0415 permits the settlor or any interested person to apply to court for reformation of a trust's terms, "even if unambiguous, to conform the terms to the settlor's intent if it is proved by clear and convincing evidence that both the accomplishment of the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement." In determining the settlor's original intent, the court may consider relevant evidence even though the evidence contradicts an apparent plain meaning of the trust instrument."[324] The comment to UTC section 415 explains that scriveners' errors frequently cause mistakes of expression.[325] On the other hand, a mistake in the inducement occurs when the terms accurately reflect the settlor's intention, but the settlor based that intention upon a mistake of fact or law.[326] The comments also distinguish a reformation from what is, in

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[313] *Compare* FLA. STAT. ANN. § 736.0814 *with* UNIF. TRUST CODE § 814 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010) (providing for powers that are similar in effect).
[314] *See* FLA. STAT. ANN. § 736.0814; I.R.C. § 2041.
[315] *Compare* FLA. STAT. ANN. § 736.0414 *with* UNIF. TRUST CODE §414 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010) (providing rights of termination that are similar in effect).
[316] FLA. STAT. ANN. § 736.0414(2).
[317] *See id.*
[318] *See id*. § 736.0414(3).
[319] *See* UNIF. TRUST CODE § 412 cmt. (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).
[320] FLA. STAT. ANN. § 736.0414(3).
[321] *See id*. § 736.0414(5).
[322] *See id*. § 736.0413.
[323] *See id*.
[324] *Id*. § 736.0415.
[325] *See* UNIF. TRUST CODE § 415 cmt. (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).
[326] *See id*.

effect, a construction to resolve an ambiguity.[327] A reformation may add or delete language from the instrument, and reliance on extrinsic evidence will be essential.[328] To protect the reliability of the extrinsic evidence, clear and convincing evidence must show that an error in expression or inducement occurred.[329]

The leading case in Florida on the reformation of a trust is *Robinson v. Robinson*.[330] *Robinson* presented an issue of first impression as to whether the testamentary aspects of an *inter vivos* trust are subject to reformation after the settlor's death.[331] According to the decedent's will, estate taxes, whether the property passed under the will or not, were to be paid from the residuary estate without apportionment.[332] The trust directed taxes to be paid out of the trust principal with sums passing from the estate divided into three sub-trusts, one of which was for the surviving spouse.[333] The will provided for a pour over to the trust.[334] The *Robinson* court confirmed its earlier holding in *In re Estate of Reese*[335] that a will cannot be reformed.[336] The surviving spouse alleged "that the will and trust contained numerous ambiguities which would allow the court to admit extrinsic evidence as proof of . . . intent."[337] In prior proceedings, the court ruled that because the provisions of the trust were not internally ambiguous and required the payment of taxes prior to establishing the marital trust, evidence supporting a finding of contrary intent was inadmissible.[338] The surviving spouse then petitioned the court to reform the trust and make it consistent with the decedent's previously established intent that the marital trust be exonerated from the payment of estate tax.[339] The court cited *Forsythe v. Speilberger,*[340] in which the court refused to invalidate a trust based upon a mistake in the inducement.[341] But the court distinguished the request for reformation in *Robinson* as being based upon a unilateral mistake in contents, not inducement.[342] In addition, the surviving spouse sought to reform, not invalidate, the trust.[343] The court concluded that the court of equity has not only the right, but the duty, to reform the instrument to conform with the grantor's intention.[344] Accordingly, the *Robinson* court held that "a trust with testamentary aspects may be reformed after the death of the settlor for a unilateral drafting mistake so long as the reformation is not contrary to the interest of the settlor."[345]

*Reid v. Temple Judea*[346] also permitted a reformation to effectuate the settlor's intent. Although the current provisions of the FTC were inapplicable to the trust, the provisions clearly informed the decision.[347] The court confirmed that a trustee has standing to bring a proceeding for reformation.[348] In addition, the court stated the following:

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[327] *See id*.
[328] *See id*.
[329] *See id*. *See, e.g.,* Eft v. Rogers, 2012 Ark. App. 632 (2012) (hearsay statements by grantor concerning her personal relationship with the residual beneficiary were not admissible in support of Trustee's action for reformation).
[330] 720 So. 2d 540 (Fla. Dist. Ct. App. 1998).
[331] *See id*. at 540.
[332] *See id*.
[333] *See id*. at 540-41.
[334] *See id*. at 540.
[335] 622 So. 2d 157 (Fla. Dist. Ct. App. 1993).
[336] *See Robinson*, 720 So. 2d at 541. The Florida legislature recently amended Florida law to conform the will statute to the FTC and permit reformation not only of a testamentary trust but also of the balance of the provisions of a will to conform the terms to the testator's intent. *See* FLA. STAT. ANN. § 732.615 (West 2010).
[337] *Robinson*, 720 So. 2d at 541.
[338] *See id*.
[339] *See id*.
[340] 86 So. 2d 427 (Fla. Dist. Ct. App. 1956).
[341] *Robinson*, 720 So. 2d at 541.
[342] *See id*.
[343] *See id*.
[344] *See id*.
[345] *Id*. at 543.
[346] 994 So. 2d 1146 (Fla. Dist. Ct. App. 2008).
[347] *See id*. at 1150 n.6.
[348] *See id*. at 1151.

> We see little distinction between the authority conferred on a trustee . . . to change or modify the terms of a trust on a claim that complying with the trust's terms will frustrate the settlor's purpose, and the authority needed to change or reform such a document so that its language accurately reflects what the settlor intended.[349]

One additional question that arises is whether one may introduce extrinsic evidence to establish the settlor's intent. Prior law did not permit the introduction of extrinsic evidence if the language of the trust was unambiguous[350] and required that an unambiguous trust be interpreted according to the grantor's intent as expressed in the document (its plain meaning).[351] On the other hand, if the instrument contains a patent ambiguity (so that the provisions are incomplete or contradictory) or a latent ambiguity (so that the provision, when applied, creates an uncertainty), construction of the instrument and the introduction of extrinsic evidence to aid that construction are appropriate.[352] Section 736.0415 changed these rules to permit the introduction of extrinsic evidence even if the terms of the trust are unambiguous.[353] *Schroeder v. Gebhart*[354] acknowledged the importance of a court's equitable powers to conform an instrument to the settlor's intention. The court held that the trial court, sitting in equity, had wide discretion in fashioning a remedy and had authority to reform a trust even though reformation was not a remedy the parties sought.[355]

Section 736.0416 (which is similar in effect to UTC section 416) permits any interested person to apply to court for a modification of a trust to achieve the settlor's tax objectives, provided the modification is not contrary to the settlor's probable intention.[356] "The court may provide that the modification has retroactive effect."[357] The comment to UTC section 416 acknowledges that the Service's recognition of a modification for tax purposes is a matter of federal tax law.[358] In the absence of specific statutory or regulatory authority, the Service generally gives a modification tax effect only if it is made before the event giving rise to the tax, such as prior to a testator's death.[359]

Section 736.0417[360] permits a trustee to combine two or more trusts or to divide a trust into two or more separate trusts "if the result does not impair rights of any beneficiary or adversely affect the achievement of the purposes of the trusts or trust."[361] Subject to the trust's terms,

> the trustee may take into consideration differences in federal tax attributes and other pertinent factors in administering the trust property of any separate account or trust, in making applicable tax elections, and in making distributions. A separate trust created by severance must be treated as a separate trust for all purposes from the date on which the severance is effective. The date of the severance may be retroactive . . . .[362]

The comment to UTC section 417 (which include only the concept expressed in section 736.0417(1)) permits a combination of two or more trusts even if the trusts do not have identical provisions.[363] However,

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[349] *Id*. at 1149-50; *see also* Popp v. Rex, 916 So. 2d 954, 958 (Fla. Dist. Ct. App. 2005) (permitting reformation of irrevocable trust that failed to make provision for death of a son without issue when the trustee made a showing, by clear and convincing evidence, of settlor's intent).
[350] *See* Robbins v. Hunyady, 498 So. 2d 955, 958 (Fla. Dist. Ct. App. 1986).
[351] *See* Riggs v. Wyroba (In re Dykes), 643 So. 2d 1132, 1134 (Fla. Dist. Ct. App. 1994).
[352] *See* Kernkamp v. Bolthouse, 714 So. 2d 655, 656 (Fla. Dist. Ct. App. 1998); *see also* Campbell v. Campbell, 489 So. 2d 774, 778 (Fla. Dist. Ct. App. 1986).
[353] *See* FLA. STAT. ANN. § 736.0415 (West 2010).
[354] 825 So. 2d 442 (Fla. Dist. Ct. App. 2002).
[355] *See id* at 446.
[356] *See* FLA. STAT. ANN. § 736.0416.
[357] *Id*.
[358] *See* UNIF. TRUST Cono § 416 cmt. (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).
[359] *See* Rev. Rul. 73-142, 1972-1 C.B. 405.
[360] *Compare* FLA. STAT. ANN. § 736.0417 *with* UNIF. TRUST CODE § 417 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010) (providing rights that are similar in effect).
[361] FLA. STAT. ANN. § 736.0417(1).
[362] *Id*. § 736.0417(2).
[363] *See* UNIF. TRUST CODE § 417 cmt. (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).

the comments go on to state that the variation in provisions typically would be limited to insignificant details, and the more the dispositive provisions differ, the more likely the variation would impair the rights of a beneficiary.[364] The division of a trust might permit the trustee to pursue different "investment objectives . . . and allow for discretionary distributions to be made from one trust but not the other."[365] The comments to the UTC even suggest that a trustee's failure to divide a trust to achieve enhanced tax benefits may be a breach of fiduciary duty.[366]

In an effort to permit ex post facto modifications to irrevocable trusts, not only to accomplish their intended purposes, but also to alter the provisions to better suit the beneficiaries, the provisions of the FTC are very broad in scope. Careful analysis of the potential tax consequences is necessary before proceeding under the authority conferred by the FTC. Evaluating the beneficial interests before and after any modification takes place—to the extent the law requires beneficiary consent—may be wise to ensure that the modification is an arm's length transaction. Even then, such a case also may warrant an income tax analysis. In *Cottage Savings Ass'n v. Commissioner*,[367] the Supreme Court held that a company realized a loss when it exchanged certain mortgage note interests for other notes that were "materially different."[368] The Service has indicated that it may view a beneficiary as experiencing a gain under *Cottage Savings* when, for example, a beneficiary's income interest is converted into a unitrust interest unless the conversion is pursuant to a state statute (or opinion of the highest court of the state).[369]

The FTC provisions dealing with reformation and modification repeatedly state that they are in addition to, rather than in derogation of, common law rights to modify, amend, terminate, or revoke trusts.[370] One should note that express statutory authority (except where a question of statutory interpretation exists) would clear the general requirement that the action taken be consistent with applicable state law for tax purposes. Therefore, the tax analysis will depend on whether beneficiaries engage in voluntary or collusive action to alter property interests in a manner that changes or diminishes those interests.

### C. The Completed Transaction Doctrine and Its Impact on Modification or Reformations of Trusts

Although permitted under state law, the act of rescinding, reforming, modifying, or terminating a trust may nevertheless have adverse tax consequences.[371] If the tax event has already taken place, an attempt to undo the action giving rise to tax consequences may fail.[372] As a general rule, a judicial reformation or other action will not change the tax consequences if the transaction in question is already complete.[373] The so-called "completed transaction" doctrine states that one cannot unwind the tax consequences of a transaction that has already taken place.[374]

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[364] *See id*.
[365] *Id*.
[366] *See id*.
[367] 499 U.S. 554 (1991).
[368] *Id*. at 566.
[369] *See* Priv. Ltr. Rul. 200013014 (Dec. 22, 1999) (ruling that the partition of the trust and changes in administrative provisions pursuant to state law would not cause the beneficiaries, whose interests remained the same in the "new" trusts as in the old, to realize gain under *Cottage Savings*). *But see* Priv. Ltr. Rul. 200736002 (May 22, 2007) (indicating that a beneficiary might realize gain if the beneficiary's interest in a successor trust, pursuant to a pro rata division of a trust, was materially different than in the original trust); Priv. Ltr. Rul. 200231011 (May 6, 2002) (ruling, under *Cottage Savings*, that a court-approved settlement under which an annuitant received a unitrust interest instead of the annuity stream constituted an income-taxable exchange).
[370] *See* FLA. STAT. ANN. § 736.0416.
[371] *See, e.g.*, Van Den Wymelenberg v. United States, 397 F. 2d 443,446 (7th Cir. 1968) (holding that amended trust agreement did not retroactively determine federal gift tax consequences).
[372] *See id*. at 445.
[373] *Id*.
[374] *See id*. at 443; Am. Nurseryman Publ'g Co. v. Comm'r, 75 T.C. 271 (1980), *aff'd without published opinion*, 673 F. 2d 1333 (7th Cir. 1982).

Courts have consistently held that retroactive changes to the legal effects of a transaction through judicial nullification of a transfer or judicial reformation of a document do not have retroactive effect for federal tax purposes.[375]

The court in *Van Den Wymelenberg* focused on the attempt to effectuate retroactive tax consequences by amendments and reformations of gifts by order of a state court in a nonadversarial proceeding.[376] The court required the Service to be a party to the proceeding to avoid the possibility of collusion, which had the effect of usurping a federal interest in collecting tax because all parties to the proceeding had a common interest in minimizing the federal tax liability."[377] On the other hand, cases such as *Dodge v. United States*,[378] examine the transaction from the standpoint of whether a completed gift occurred when the donor, based on a mistake, transferred property that the donor did not intend to transfer. Under *Dodge*, the transfer is incomplete because the donor, having a remedy in state court to undo the mistake, had not given up dominion and control of the property, and thus Treasury Regulation section 25.2511-2 precluded the making of a completed gift.[379] In *Dodge*, the Service was a party to the proceeding.[380] Taxpayers have been more successful recently, particularly in Massachusetts.[381]

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[375] *See* Am. Nurseryman Publ'g Co., 75 T.C. at 276-77 (1980) (holding nunc pro tunc voiding of transfer that otherwise destroyed S-corporation election entered in state court action to which the United States was not a party did not affect federal income tax liability for already completed years); Estate of Hill v. Comm'r, 64 T.C. 867, 879 (1975), *aff'd without published opinion*, 568 F. 2d 1365 (5th Cir.1978); Emerson Inst. v. United States, 356 F. 2d 824, 826-27 (D.C. Cir. 1966) ("[T]he law appears well established that a none pro tunc decree in proceedings to which the.... Service is not a party is not binding on that Service for tax purposes... [The] decree could, at best, have operative consequences only as between the parties to the action in which it was entered." (citations omitted)); Piel v. Comm'r, 340 F. 2d 887, 891 (2d Cir. 1965); M.T. Straight Trust v. Comm'r, 245 F. 2d 327, 329-30 (8th Cir. 1957) (declining to alter federal tax liability that had accrued on the ground that nunc pro tunc reformation of trust does not alter the federal tax liability where United States is not made a party to the reformation action and holding "that it is both inequitable and beyond the power of a State Court to change retroactively the status of a federal revenue measure with a resulting loss of revenue to the government"); Eisenberg v. Comm'r, 161 F. 2d 506, 511 (3d Cir. 1947); Sinopoulo v. Jones, 154 F. 2d 648, 651 (10th Cir. 1946); Rev. Rul. 93-70, 1993-2 C.B. 269 (concluding that the retroactive reformation of a trust instrument to eliminate a provision permitting distributions to persons other than the income beneficiary would not retroactively cause the trust to be a qualified subchapter S trust within the meaning of section 1361(d)(3)). *See generally* Barry F. Spivey, *Completed Transactions, Qualified Reformation and Bosch: When Does the IRS Care about State Law of Trust Reformation?*, 24 ACTEC L.J. 345 (2001) (asserting that retroactive changes have consistently had no retroactive effect for federal tax purposes).

[376] 397 F. 2d 443 (7th Cir. 1968).

[377] *See id*. at 445 (denying retroactive tax consequences to amendments and reformation of gifts by state court in no adversarial proceedings when there is an issue of collusion and holding that "not even judicial reformation can operate to change the federal tax consequences of a completed transaction").

[378] 413 F. 2d 1239 (5th Cir. 1969).

[379] *See id*. at 1243.

[380] *See id*. It would not appear that the taxpayer has the ability to make the Service a party to any proceeding. *See* Spivey, *supra* note 299, at 346.

[381] *See* O'Connell v. Houser, 470 Mass. 1004 (2014) (authorizing a reformation to add the words "by blood" to the rule against perpetuities savings clause of a GST exempt trust created by decedent by exercise of a power of appointment to avoid the potential loss of GST exempt status due to the inclusion of adopted persons in the class of issue which may have impermissibly extended the time for vesting; note that the parties argued, and the court accepted, the application of the rules applicable to trusts exempt by reason of being irrevocable prior to September 25, 1985 to trusts exempt by reason of an allocation of GST exemption); Breakiron v. Gudonis, No. 09-10427-RWZ, 2010 WL 3191794 (D. Mass. Aug. 10, 2010) (permitting the rescission of tax defective disclaimer of remainder interest in QPRT to avoid a $2.3 million gift tax liability); Kaufman v. Richmond, 811 N.E. 2d 987 (Mass. 2004) (disclaimer of inherited property reformed so that it would not exceed decedent's remaining GST exemption); DiCarlo v. Mazzarella, 717 N.E. 2d 257 (Mass. 1999) (allowing reformation of scrivener's error when "clear and decisive proof" showed settlor intended to qualify for federal estate tax marital deduction); *see also* Neal v. United States, 83 A.F.T.R. 2d 99-2325, 99 -2327 (3rd Cir. 1999) (holding that rescission for mistake of law eliminated gift tax liability); First Security Bank v. United States, 87 A.F.T.R. 2d 2001-2211 (D.C. N.M. 2001) (holding that transfer in trust for husband was incomplete and therefore voidable under New Mexico law because it was implicitly conditioned upon a timely execution of a QTIP marital deduction election), *reversed sub nom*. Wells Fargo Bank N.M., N.A. v. United States, 319 F. 3d 1222 (10th Cir. 2003); Griffin v. Griffin, 832 P. 2d 810 (Okla. 1992) (holding that evidence of

Some suggest that a mistake involving the wrong asset differs from a mistake of law, but courts tend to permit rescission based upon either type of mistake. In *Breakiron v. Gudonis*, the court stated "the mistake was not a mere 'scrivener's error,' [but] it was a mistake at the time [of disclaimer] — not a hindsight decision by plaintiff to avail himself of a tax advantage."[382] If, as the court found, state law permits such a rescission,[383] can one conclude that the donor has not parted with dominion and control because the donor possesses the state law right to retrieve the property based upon the mistake of law and unintended tax consequences? This appears to be the logic of *Breakiron*.

In *Berger v. United States*,[384] the court held that a mistaken transfer was not a completed gift by virtue of the equitable right of reformation.[385] Misunderstanding the conflict rules pertaining to political appointees, the taxpayer sought political appointment, liquidated his property, and transferred it to two irrevocable trusts for the benefit of his wife and children.[386] The taxpayer then sought judicial reformation of the trusts to make them revocable, which the court granted.[387] The district court held that the gift into trust was incomplete for mistake and thus not subject to transfer tax.[388] Note that the UTC expressly permits modifications to achieve a settlor's tax objectives as long as those modifications are not contrary to the settlor's probable intent.[389]

In *Neal v. United States*, the U.S. Court of Appeals for the Third Circuit similarly affirmed a district court decision granting the taxpayer a refund of gift taxes paid when she acted under a mistake of law.[390] The taxpayer, a trust grantor, released all of her contingency reversionary interest in her GRIT and then attempted to rescind her action.[391] Because she was mistaken as to what effect the law would have on her tax liabilities, both the state and federal courts found she originally released her interests under a mistake of law and as such could rescind her actions, resulting in the tax refund.[392]

On a number of occasions, the Service has ruled in favor of permitting the reformation of an irrevocable trust to have retroactive effect.[393] In Private Letter Ruling 200219012, the Service ruled that a state court's rescission of a charitable remainder trust would be recognized as effective as of the date of the trust's creation where the beneficiary charity had incorrectly (though apparently innocently) represented the tax treatment of the transfer to the trust.[394] In Private Letter Ruling 200106008, the Service ruled that a court order reforming a will based on a scrivener's error is consistent with state law as the state's highest court would have applied it.[395] Accordingly, the Service recognized that the surviving spouse had a qualifying income interest for life for purposes of the federal estate tax marital deduction.[396] The error arose out of the inclusion of language permitting discretionary payments of principal to the deceased spouse's descendants,

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mistake clear and tax objectives can be considered in determining intent and reforming trust to delete language objectionable for marital deduction purposes).

[382] *Breakiron*, 2010 WL 3191794, at *6; *but see* In re Ishida-Waiakamilo Legacy Trust, 377 P.3d 39 (HI App. 2016) (parents, as settlors of an irrevocable trust were successful in causing the beneficiary to return property improperly removed from the trust, but were unsuccessful rescinding the trust for mistake).

[383] *See id*. at *3.

[384] 487 F. Stipp. 49 (W.D. Pa. 1980).

[385] *See id*. at 52.

[386] *See id*. at 50.

[387] *See id*.

[388] *See id*. at 52.

[389] *See* . UNIF. TRUST CODE § 416 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010).

[390] Neal v. United States, 83 A.F.T.R. 2d 99-2325, 99-2325 (3d Cir. 1999).

[391] *See id*. at 99-2326.

[392] *See id*. at 99-2327 to -2328.

[393] *E.g*., Priv. Ltr. Rul. 200219012 (May 10, 2002); Priv. Ltr. Rul. 200106008 (Feb. 9, 2001); Priv. Ltr. Rul. 200144018 (Nov. 2, 2001).

[394] *See* Priv. Ltr. Rul. 200106008 (Feb. 9, 2001).

[395] *See id*.

[396] *See id*.

which language the reformation removed upon the Service's determining that the decedent intended the invasion provision to apply only to the residuary, nonmarital trust.[397]

In Private Letter Ruling 200144018, the Service approved reformation of a scrivener's error, and thus the decedent neither held nor released a general power of appointment.[398] The Service stated that "if, due to a mistake in drafting, the instrument does not contain the terms of the trust that the settlor and the trustee intended, the settlor or other interested party may maintain a suit in equity to have the instrument reformed so that it will contain the terms that were actually agreed upon."[399]

Apparently, the modern interpretation of the completed transaction doctrine permits alteration, without adverse tax consequences, of a transaction that otherwise appears complete if the taxpayer can demonstrate that due to a mistake of fact or law, the transaction has an effect the transferor did not intend at the time of the transfer. The notion is that because the transferor has available the remedy of rescinding or modifying the transaction under state law as a result of the mistake, the transaction is incomplete for gift tax purposes. Moreover, Revenue Ruling 81-264 might apply to this scenario by analogy. Just as the loan at issue in the ruling did not become a gift until the loan's statute of limitations ran, a transfer that one may rescind under state law might remain an incomplete gift until the right to rescind expires.[400]

D. *Bosch* and the Importance of State Law

In *Commissioner v. Estate of Bosch,*[401] the Supreme Court concluded that a state trial court's determination of a property interest does not conclusively bind federal authorities, including the Service, when the state trial court makes the determination in a proceeding to which the United States is not a party. This holding echoes *Van Den Wymelenberg*'s statement that a proceeding to which the Service is not a party is potentially collusive and should not usurp a federal interest in collecting tax.[402] In a case consolidated into the Bosch decisions, the District Director of the Service was provided notice of application but did not appear.[403] The Government argued that a state trial court's adjudication is binding only when the judgment is the result of an adversary proceeding in the state court.[404] The Supreme Court followed *Erie v. Tompkins*[405] in holding that federal authorities must follow the state law as announced by the highest court of the state; however, "lf there be no decision by that court then federal authorities must apply what they find to be the state law after giving 'proper regard' to the relevant rulings of other courts of the State.[406]

In *Estate of Kraus v. Commissioner*,[407] the U.S. Court of Appeals for the Seventh Circuit upheld the Tax Court's decision not to respect a state court's reformation of an irrevocable insurance trust; the trial court based its reformation on a scrivener's error. The Seventh Circuit determined that the estate did not show, by clear and convincing evidence, mistake by the Tax Court and held that the Tax Court had given proper regard to the ruling of the state court even though it reached a contrary result.[408]

Some tension exists between the *Bosch* standard and Treasury Regulation section 25.2512-8. *Bosch* requires a state trial court decision to be consistent with the law as expressed by the state's highest court for

[397] *See id*.
[398] *See* Priv. Ltr. Rul. 200144018 (Nov. 2, 2001).
[399] *Id*. (citing MARY F. RADFORD, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 991 (Rev. 2d ed. 1983)).
[400] *See* Rev. Rul. 81-264, 191-2 C.B. 185. For a discussion of Revenue Ruling 81-264, see *supra* notes 92-102 and accompanying text.
[401] 387 U.S. 456 (1967).
[402] *See* Van den Wymelenberg v. United States, 397 F. 2d 443, 445 (7th Cir. 1968).
[403] *See* Bosch, 387 U.S. at 465.
[404] *See id*.
[405] U.S. 64 (1938).
[406] Bosch, 387 U.S. at 465, 475. See generally Paul L. Caron, *The Role of State Court Decisions In Federal Tax Litigation: Bosch, Erie, and Beyond*, 71 OR. L. REV. 781 (1992).
[407] 875 F. 2d 597 (7th Cir. 1989).
[408] *Id*. at 601.

the decision to bind federal authorities for tax purposes[409] (and for the estate to potentially avoid a taxable gift). Treasury Regulation section 25.2512-8 permits the settlement of a bona fide dispute without tax consequences, even if the settlement is not consistent with state law, as long as it is the product of an arm's length compromise in the ordinary course of business between the litigants.[410] Indeed, the GST regulations also appear to permit a taxpayer to avoid an adverse result through a settlement that is the product of arm's length negotiations if the settlement is within the range of reasonable outcomes had the dispute been litigated to conclusion.[411]

One might reconcile this tension on the basis of the *Van Den Wymelenberg* requirement that federal authorities need not respect a state court decision from a potentially collusive proceeding,[412] which implies that they should respect a decision not from a collusive proceeding. By definition, an arm's length settlement between parties advocating for differing outcomes is not collusive. Thus, if parties dispute the construction of an instrument and advocate for and against the particular construction, the result should not constitute a gift between the parties who settle the case, even if one of the parties determines not to pursue its position based upon a business determination that the risk of litigation is not worth the cost. Perhaps the real distinction is whether or not the particular action involves opposing parties, as opposed to a one-sided action by the taxpayer to unwind a transaction that had an adverse tax result.

Another possibility is to arrange for a determination by the highest court of the state. In *In re Trust D Created under Last Will and Testament of Darby*,[413] the taxpayer perfected an appeal to the Supreme Court of Kansas by arguing that the Service would not be bound by the lower court's order approving modifications to a trust unless the state's highest court validated it.[414] Unfortunately for the taxpayer, the Kansas Supreme Court undid the relief she achieved in the lower court.[415] The beneficiary sought modifications to an irrevocable trust created by her father.[416] The court construed the proposed modifications under the Kansas version of the UTC.[417] Kansas enacted UTC section 411(b) permitting a court to terminate a trust upon the consent of all qualified beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust.[418] In addition, Kansas enacted UTC section 412(a) permitting a court to 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 would further the purposes of the trust.[419] To the extent practicable, the court must make the modification in accordance with the settlor's probable intention.[420] Contrary to the UTC, Kansas law presumes that a spendthrift clause constitutes a material purpose.[421] As a result, the court could not modify the trust, which contained a spendthrift clause, to permit an increase in the mandatory distributions that the trust required the trustee to make to the life beneficiary.[422] Nor could the court modify the trust to grant a limited testamentary power of appointment, which the beneficiary alleged would permit the beneficiary's tax benefits to shelter the trust from transfer tax.[423] The court held that a modification to achieve a more favorable tax result is different from a modification to achieve the settlor's probable tax intent.[424] In

[409] *See* Bosch, 387 U.S. at 464-65.
[410] *See* Treas. Reg. § 25. 2512-8.
[411] *See id*. § 26. 2601-1(b)(4)(B).
[412] *See* Van Den Wymelenberg v. United States, 397 F. 2d 443, 445 (1968).
[413] 234 P. 3d 793 (Kan. 2010).
[414] *See id*. at 796.
[415] *See id*. at 804.
[416] *See id*. at 797-98.
[417] *See id*. at 798-99.
[418] *See id*.
[419] *See id*. at 799.
[420] *See id*.
[421] *See id*. at 799-800.
[422] *See id*. at 795.
[423] *See id* at 801.
[424] *See id*. at 801-04.

addition, the proposed changes were in derogation of the interests of the other beneficiaries.[425] Accordingly, the court denied the proposed relief.[426]

Similarly, in *In re Trust Under Will of Wallace B. Flint*,[427] the Delaware Chancery Court refused to grant the beneficiary of a testamentary trust permission to modify the trust's administrative terms to convert to a directed trust on the basis that the modification was deemed to run counter to the settlor's intent.

In any event, among the completed transaction doctrine, *Bosch*, and Treasury Regulation section 25.2512-8, one has choices as to how to modify an irrevocable trust to avoid adverse gift tax consequences that result from its creation or cause among its beneficiaries.[428]

E. Revenue Ruling 73-142 and the Tax Effect of Prospective Changes

Revenue Ruling 73-142 provides another opportunity to alter the tax consequences of an irrevocable trust, provided the tax consequences one seeks to alter are prospective.[429] In the ruling, the decedent made substantial gifts of property to a trust for his wife and children.[430] "Under the terms of the trust instrument, the decedent reserved the unrestricted power to remove or discharge the trustee at any time and appoint a new trustee, with no express limitation on so appointing himself."[431] The trustee had an unrestricted power to withhold distributions and to apportion income and principal.[432] The state court construed the decedent's power as permitting removal and appointment of a trustee only once and excluding the power to appoint himself trustee.[433] The court's decree was, however, contrary to the decision of the highest court of the state.[434] The ruling concludes that *Bosch* does not void a lower court decree that is binding on the parties.[435] Once the time for appeal elapses such that the decree binds the parties, the decree determines the parties' property rights.[436] Accordingly, before the taxing event (the decedent's death), the law of the case cut off the section 2036 and 2038 powers that otherwise might have attracted estate tax.[437] The decree extinguishing the powers would therefore bind the Service, as the decedent clearly lacked the powers after the decree.[438]

Thus, if a modification for the purpose of avoiding tax consequences does not itself have tax consequences—for example, the surrender of a current property interest—a prospective ruling to eliminate a power with future tax consequences appears possible so long as the court decree thereafter binds the taxpayer and cannot be undone.

F. Modification by Decanting

In *Morse v. Kraft*,[439] the Massachusetts Supreme Judicial Court, in an action brought by the trustee for declaratory relief, became the second court squarely to address whether, under common law, the trustee of a discretionary trust has the power to exercise the trustee's discretion by distributing trust property to a new trust for the beneficiaries of the original trust, without the beneficiaries' consent or court approval. Although the *Morse* court determined that the trustee had the authority to decant, the *Morse* decision could

[425] *See id*. at 801.
[426] *See id* at 804.
[427] 118 A3d 181 (2015).
[428] *See* M. Gans, *Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?* 48 EMORY L.J. 871 (1999).
[429] *See* Rev. Rul. 73-142, 1973-1 C.B. 405.
[430] *See id*.
[431] *Id*.
[432] *See id*.
[433] *See id*.
[434] *See id*.
[435] *See id*. (citing Comm'r v. Estate of Bosch, 387 U.S. 456 (1967)).
[436] *See id*.
[437] *See id*.
[438] *See id*.
[439] *See* Morse v. Kraft, 466 Mass. 92 (2013).

be perceived as far narrower than most would have liked. The court was particularly focused on the discretionary language in the trust instrument expressly permitting distributions "for the benefit" of the beneficiaries, and indicated that given the widespread awareness of decanting, a more recent trust instrument without express decanting authority may create a negative inference that the settlor intentionally omitted the power.[440]

Before *Morse,* the only case directly to address the common law authority to decant is the Florida Supreme Court case of *Phipps v. Palm Beach Trust Company,*[441] which held that a trustee with absolute discretion to distribute trust property "to" its beneficiaries could appoint the entire trust to another trust for its beneficiaries. An interesting aspect of the *Phipps* opinion is that the second trust in question granted the primary beneficiary of the first trust a testamentary power of appointment in favor of the beneficiary's spouse who was not a beneficiary under the first trust. The granting of a testamentary power of appointment in favor of persons who were not beneficiaries under the first trust would appear to derive from the trustee's ability to distribute property outright to a beneficiary, after which the beneficiary could certainly deflect the property to whomever the beneficiary might choose.[442]

In affirming that decanting authority exists under the common law, the Florida Supreme Court in the *Phipps* opinion held that,

> "[t]he general rule gleaned from … cases of similar import is that the power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent."[443]

The court in *Phipps* rejected the respondent's argument that the reverse was true, i.e., that the power to create a second trust estate is present under a special power of appointment only where such authority is specifically granted.[444] The court relied on the Restatement of the Law of Trusts, section 17, for the proposition that if a trustee has a special power of appointment, that is a power to appoint among the members of a specified class, then whether the trustee can effectively appoint a trustee for members of the class depends upon the terms of the power vested in him. Thus, the court concluded that, so long as the beneficiaries of the second trust are limited to the class of beneficiaries under the first trust, the power in the trustees to appoint in further trust, much like a power of appointment, is absolute, and to hold otherwise would limit the power of the individual trustee to administer the trust estate in a way not contemplated by the donor of the first trust.

The court in *Morse* declined to follow *Phipps* to that degree. Instead, the court was more inclined to adopt the reasoning of *Wiedenmayer v. Johnson*,[445] wherein the court, finding the trustee to have absolute and uncontrolled discretion, permitted a decanting for the beneficiary's "best interests". Although *Wiedenmayer* is cited as a decanting case, *Wiedenmayer* actually concerned an indirect decanting in that the trustees exercised their power of invasion in favor of the beneficiary contingent upon the beneficiary agreeing to transfer the property in further trust. The court concludes the transfer was in the beneficiary's best interests, describing "best interests" as follows:

> "The expression is not limited to a finding that distribution must be to the son's best 'pecuniary' interests. His best interests might be served without regard to his personal financial gain. They may be served by the peace of mind, already much disturbed by matrimonial problems, divorce and the consequences thereof, which the second trust,

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[440] The court repeatedly cited W. Culp & B. Mellen, "Trust Decanting*:* An Overview and Introduction to Creating Planning Opportunities," 45 RPTELJ 1 (Spring 2010) and D. Zeydel & J. Blattmachr, "Tax Effects of Decanting – Obtaining and Preserving the Benefits," 111 JTAX 288 (November 2009).
[441] 142 Fla. 782, 196 So. 299 (1940).
[442] *Id.* at 787, 301.
[443] *Id.* at 786, 301.
[444] *Id.*; *see also* BOGERT'S TRUSTS AND TRUSTEES (through 2011 Update), Chapter 39, § 812, under the discussion of the express (and unlimited by an ascertainable standard) power in the Trustees to distribute principal.
[445] 106 N.J. Super. 161, 254 A.2d 534 (App. Div.), *aff'd sub nom.,* Wiedenmayer v. Villaneuva, 55 N.J. 81, 259 A.2d 465 (1969).

> rather than the old contingencies provided for in his father's trust indenture, will engender. Of what avail is it to rest one's 'best interests' on a purely financial basis, and without regard to the effect upon a man's mind, heart and soul, if the end result would produce a wealthier man, but a sufferer from mental anguish?"

In *Wiedenmayer*, the authority to distribute in the trust instrument included the words "to use for or to distribute and pay to." And the court, as in *Phipps*¸ construed the authority to distribute to the beneficiary "absolutely, outright and forever" to include the power to safeguard the beneficiary's interests by conditioning the distribution upon his setting up a substituted trust. Thus, the *Wiedenmayer* court did not rely on the authority "to use for" language in the trust agreement, but rather found the authority to distribute in further trust to be encompassed in the ability to distribute outright. The distribution authority expressly required a finding that it be for the beneficiary's best interests, causing the court to analyze whether the distribution would satisfy that standard. Indeed, the consequences of the new trust were that two of the beneficiary's children would lose their remainder interests in the original trust, which the court observed would also have occurred had the distribution been outright to the son. The dissent notes, however, that prior requests for outright distributions had been denied by the trustees. Accordingly, the court found it necessary to condition the distribution on the beneficiary's agreement to contribute the assets to a new trust for his benefit.

A power held by a trustee to invade the corpus of a trust closely resembles a power of appointment for property law purposes.[446] Indeed, as a general rule, the holder of a power of appointment may appoint the property in further trust, which is exactly what the trustee possessing a decanting power does.[447] The court in *Morse* cited its prior decision prospectively authorizing the donee of a non-fiduciary power of appointment to exercise the power in further trust in support of its conclusion that a trustee with discretionary distribution authority may do the same.[448] This connection further suggests that if a decanting power is similar to a power of appointment, then, unless the instrument provides otherwise, a trustee who may invade the corpus of a trust may pay it to a different trust for the benefit of the beneficiary or beneficiaries for whom it may be invaded, even if the power to invade does not specifically state it may be exercised "for the benefit of" the beneficiary.[449]

Because the power to decant is deemed held by the trustee, it is, by definition, a fiduciary power. The *Comments* to *Restatement (Third) of Trusts* section 75 draw a distinction between powers held in a fiduciary capacity and those that are held for the power holder's own benefit. The discussion echoes the conclusions reached in the Reporter's Notes to section 64 of the *Restatement (Third) of Trusts* which also draws a distinction between a personal power that may be exercised for the personal benefit of the donee of the power and a fiduciary power which must be exercised for the purpose for which the settlor created it. The Reporter's Notes to section 64 indicate that if the power holder's power is personal, the trustee's only duty is to ascertain whether the attempted exercise is or is not within the terms of the trust.

The *Restatement (Second) of Property, Donative Transfers* section 11.1 (1986) took the position that a power of appointment could be held in a fiduciary capacity and that a power of appointment may be exercised in further trust (see section 19.3 thereof). The foregoing distinction between personal and

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[446] If the trustee can invade for his or her own benefit, then the power of invasion may constitute a general (estate taxable) power of appointment under sections 2514(c) and 2041(b). The power to invade for one's own benefit (that is, to withdraw property from the trust) may cause the power holder to be the owner of the trust for purposes of section 671 so that the income, deductions and credits against tax of the trust are attributed to the power holder. *See* I.R.C. § 678(a). However, if the power is held in a fiduciary capacity, section 678 may not apply. See discussion in Blattmachr, Gans & Lo, *"A Beneficiary as Trust Owner: Decoding Section 678,"* ACTEC JOURNAL, Fall 2009.

[447] *See, generally,* SCOTT ON TRUSTS §3.1.2 at 144–45 (5th ed. 2008) (the trend is to construe the language conferring a power of appointment with increasing liberality, and to hold that the donee of the power has broad discretion as to the manner in which the power may be exercised).

[448] Loring v. Karri-Davies, 371 Mass. 346, 357 N.E.2d 11 (1976).

[449] *See, e.g.,* RESTATEMENT (THIRD) OF PROPERTY (WILLS & OTHER DONATIVE TRANSFERS) § 19.14 (2011) (except to the extent the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment, including one in trust and one that creates a power of appointment in another, that solely benefits permissible appointees of the power.)

fiduciary powers may explain why the *Restatement (Third) of Property (Wills & Other Donative Transfers)* section 17.1 (2011) clarifies that a fiduciary distributive power is a power of appointment but is not a discretionary power of appointment that may be exercised arbitrarily.[450] The donee of a power of appointment would seem to have no affirmative duty to act in good faith and could exercise a power of appointment to exclude a person from beneficial enjoyment for personal reasons.[451] A fiduciary, on the other hand, would be precluded by fiduciary duties from acting in a similar manner. Instead, a fiduciary would seem always to be held to a minimum standard of good faith, with an obligation to act consistently with the terms of the trust and the interests of the beneficiaries.[452]

Notwithstanding the foregoing authorities, the *Morse* court's holding is far more narrow. The court relies on fundamental principles that in interpreting a trust, the intent of the settlor is paramount.[453] In determining the settlor's intention, the language of the trust instrument is of particular significance. In addition, in the case of the *Morse* trust, all of the settlor, the attorney/draftsperson and the trustee were available to submit affidavits confirming the settlor's intention. The availability of such extrinsic evidence may be a rare event in the case of an irrevocable trust established prior to the effective date of chapter 13 of the Code. It is interesting, nonetheless, that the court was quite aware of the particular Treasury Regulation that the trustee was attempting to satisfy, namely, Treasury Regulation section 26.2601-1(b)(4)(i)(A)*(1)(i)* which requires that the authority to distribute to a new trust must have been authorized by the terms of the governing instrument of the original trust without consent or approval of any beneficiary or court.

The *Morse* court states that "[a] trustee can only exercise a decanting power, however, in keeping with fiduciary obligations." Although the court finds that decanting authority was present, the court states in footnote 6 that it is not passing judgment on whether the transfer of assets to the new subtrusts was, in fact, in the beneficiaries' best interests or in keeping with the trustee's fiduciary duties. The court considered only the question of whether the trust authorizes such a transfer. This holding appears to raise the question of whether the decanting may have been avoided by the beneficiaries, nonetheless, as a breach of trust, which could, at a minimum, have tax consequences to the beneficiaries who fail to object.[454] Whether the exercise of authority that turns out to be a breach of trust can satisfy Treasury Regulation section 26.2601-1(b)(4)(i)(A)*(1)(i)* seems doubtful.

*Morse v. Kraft* is certainly a welcome development in the jurisprudence on decanting, although it can be interpreting as limited to trusts that permit distributions "for the benefit" of the beneficiaries. The court squarely held that the trustees had the authority to distribute in further trust without the need for beneficiary consent or court approval. It may be that the court was concerned that deriving decanting authority from a power to distribute outright would require a finding that an outright distribution is appropriate. However, neither the *Phipps* court nor the *Wiedenmayer* court so held. Instead, both those courts construed decanting as a lesser included power when a trustee may invade outright in favor of a beneficiary. Indeed, one might conclude that a trustee, constrained by a fiduciary duty to act in the best interests of the beneficiaries, must always consider the benefits of a distribution in further trust, rather than outright, because a distribution in trust has the potential to give a beneficiary superior tax and creditor protection, while at the same time affording the beneficiary flexibility that the original trust may not have provided. It will be intriguing to

[450] Comment *g* states "*g. Fiduciary distributive powers.* A fiduciary distributive power is a power of appointment (a nongeneral power), but it is not a discretionary power of appointment. In the case of a discretionary power of appointment, which is the principal subject of this Division, the donee may exercise the power arbitrarily as long as the exercise is within the scope of the power. ... In the case of a fiduciary distributive power, the fiduciary's exercise is subject to fiduciary obligations as provided in the Restatement (Third) of Trusts." *citing* RESTATEMENT (THIRD), TRUSTS §§ 86 and 50, Comment a.

[451] *See* RESTATEMENT (THIRD) OF TRUSTS § 50 (2003), Comment *a*: "A trustee's discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power."

[452] *See* UNIF. TRUST CODE § 105 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010) which prohibits a trust instrument from exonerating a trustee's duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

[453] *See, e.g.*, Hillman v. Hillman¸ 433 Mass. 590, 744 N.E.2d 1078 (2001).

[454] *See generally*, D. Zeydel, "Developing Law on Changing Irrevocable Trusts*:* Staying Out of the Danger Zone", 47 Real Prop. Tr. & Est. L.J. 207 (2012).

see if further case law develops. For now decanting was from the most recent Priority Guidance Plans published by the Department of Treasury, placing greater importance on flexible drafting (recall that the *Morse* court indicated a potential negative inference from the absence of a decanting power in a current trust instrument) and state law developments.

In *Harrell et al. v. Badger,*[455] the Trustee exercised decanting authority under FTC section 736.04117 without providing notice to the qualified beneficiaries. The purpose of the decanting was to qualify the income beneficiary for government benefits by decanting into a special needs trust as a sub-account of the Florida Foundation for Special Needs Trust ("FFSNT). The court determined that the decanting was invalid for failing to comply with the requirements of Section 736.04117 with respect to advance notice. The court also held that the decanting violated the prohibition on introducing additional beneficiaries into the trust because an FFSNT sub-account provides a contingent interest in favor of other FFSNT subaccounts.

The court did not analyze the portion of FTC section 736.04117 which expressly states that the decanting statute does not abridge the right of a trustee who has a power of invasion to appoint property in further trust that arises under the common law. This provision was intended expressly to permit a decanting under the authority of *Phipps* without the obligation to provide advance notice.

In *In re Kross,*[456] the Trustees also sought approval for invading a trust for the benefit of a beneficiary with disabilities to ensure qualification for Medicaid and Supplemental Security Income benefits. The Attorney General of the State of New York on behalf of the New York State Department of Health objected. The invaded trust was a fully discretionary trust as to income and principal payments until the beneficiary attained age 21, whereupon the beneficiary would become entitled to income in quarterly installments and principal one-third at age 25, one-half the balance at age 30 and the remainder at age 35. Advocating a bizarre reading of the New York decanting statute, the Attorney General argued that the Trustees were not "authorized trustees" with the power to decant. The court disagreed. The Attorney General also argued that the beneficiary's right to principal distributions became vested when the beneficiary attained age 21, and because the decanting did not validly take place prior to that date, the decanted trust was a self-settled trust that did not qualify as a supplemental needs trust. At issue was the validity of the notice of decanting and waiver of the thirty day notice period under the statute. The Trustees gave notice less than thirty days prior to the date the beneficiary attained age 21. The beneficiary's father (who was neither the grantor nor a Trustee) executed a consent to the decanting taking effect immediately. The beneficiary's father was expressly authorized to receive notice and consent on behalf of the beneficiary by the trust agreement. Accordingly, the court found the consent to be valid and effective to permit the decanting to take place five days after notice was given and prior to the beneficiary attaining age 21.

In *Ferri v. Powell-Ferri,*[457] one of the parties to a proceeding for dissolution of marriage was the beneficiary of a third party trust. The trust was governed by Massachusetts law and provided that upon attaining age 35, the beneficiary would have periodically increasing rights to withdraw principal from the trust. At the time divorce proceedings were initiated, Ferri had the right to withdraw 75% of the trust estate. During the pendency of the proceedings, his withdrawal right would have increased to 100%. The Trustees of the trust, after the divorce proceedings commenced, decanted the trust to a new trust that eliminated the current and future withdrawal rights, and included spendthrift provisions. The Trustees

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455 2015 WL 3631639 (5th DCA 2015) Not Final until Time Expires to File Motion for Rehearing and Disposition Thereof if Filed. *See* Petition of Johnson, 2011-2809/B, NYLJ 1202718164118, at *1 (Surr., NY, Decided January 13, 2015) (decantings that changed the class of permissible appointees under the beneficiary's limited testamentary power of appointment from issue of the beneficiary's mother to issue of the beneficiary's father, and expanded the class of ultimate takers in default to eliminate the New York City Ballet and include intestate distributees of the beneficiary's father were invalid under EPTL 10-6.6(b) and assets were to be returned to the original trusts). It seems that the Johnson court's determination that altering the permissible appointees under a power of appointment constitutes an impermissible addition of beneficiaries to the trust is incorrect. Indeed, in *Phipps*, the beneficiary had no power of appointment at all, and the court permitted a power of appointment to be conferred which was exercisable in favor of the beneficiary's wife, who was not a beneficiary of the original trust.

456 2013 WL 5478190 (Surr. Ct. NY Cty 2013).

457 326 Conn. 457 (2017) and 326 Conn. 438 (2017).

instituted a declaratory action seeking a ruling that they had validly exercised their authority to transfer the assets to the new trust and that the beneficiary's spouse had no interest in the assets of the new trust. The beneficiary's spouse asserted claims of fraud, conspiracy and breach of the requirement not to dissipate marital assets. The court found that because the beneficiary did not participate in the decanting, the beneficiary had no duty to thwart the removal of assets from the marital estate by the Trustees. In addition, the beneficiary had no affirmative duty to recover the marital assets "taken by a third party."

During the course of the proceedings, the Supreme Court of Connecticut certified three questions to the Supreme Judicial Court of Massachusetts: (1) Under Massachusetts law, did the terms of the trust empower its trustees to distribute substantially all of its assets (that is, to decant) to the new trust; (2) if the answer to (1) is "no", should either 75% or 100% of the assets be returned to the original trust; and (3) under Massachusetts law, should a court, in interpreting whether the original trust's settlor intended to permit decanting to another trust, consider an affidavit of the settlor offered to establish the settlor's intent.[458] The Massachusetts court answered question (1) and question (3) in the affirmative, obviating the need to answer question (2).

As in *Morse v. Kraft*, the Massachusetts court refused to recognize a common law authority to decant, but rather, looked to the specific language of the governing instrument to determine whether the settlor intended to confer such authority. The court focused on the language stating that so long as the beneficiary is living, the trustee shall "from time to time, pay to *or irrevocably segregate for later payment to* [the beneficiary] as much of the net income and principal of the trust as [the trustee] shall deem desirable for [the beneficiary's] benefit." (Emphasis added). Powell-Ferri argued that the withdrawal powers held by Ferri were wholly inconsistent with the trustee's authority to decant. The court disagreed because it would follow that the trustee would lose the ability to administer the assets subject to withdrawal, which would make little sense in view of the language giving the trustee authority to pay to or segregate assets for later payment to the beneficiary during the beneficiary's lifetime. The court pointed out that the trustees continued to hold legal title to the assets, notwithstanding the withdrawal rights, and therefore, had all the authority to administer those assets conferred by the trust agreement. Nonetheless, because the governing instrument did not contain an express authorization to decant, the court found that there to be an ambiguity, permitting consideration of the settlor's affidavit which confirmed his intention that the trustees were authorized to take any action necessary to protect the principal and income of the trust which authority also extended to protecting the assets from the creditors of the beneficiary.

The *Ferri* case might seem incorrect to some, and certainly most decanting statutes do not permit decanting of assets subject to a presently exercisable power of withdrawal, whether a *Crummey* power or a power such as the one held by Ferri. Nonetheless, the Massachusetts court's interpretation of the Ferri trust turned out to be very beneficial to Ferri, as it prevented the trust estate from being considered a marital asset. How important it may have been to the court that the trust estate was largely accumulated during the marriage, and used for investments in franchises, is unknown. The Connecticut court repeated several times that Ferri did not instigate the decanting, or even know about it.

The *Ferri* cases certainly demonstrate the potential benefits of a decanting power, and confirm the holding of *Phipps* that the ability to distribute in further trust derives from the trustee's broad discretion to distribute outright on a principle that the greater includes the lesser. Accordingly, even without express language in the governing instrument, or a state statute, decanting should not be overlooked as a powerful solution that in many ways may be more flexible that a court ordered modification or reformation.

G. Modification Using Trust Protector Powers

Another method whereby an irrevocable trust may be modified is by conferring express authority to modify the trust instrument upon either a trustee or a trust protector. The use of trust protector powers has become more widespread. And it seems that courts are inclined to respect a trust protector's exercise of express authority conferred by the governing instrument, regardless of how dramatic the consequences of that exercise may be on the outcome of a pending litigation.

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

In *Devitt v. Wellin*,[459] the trustee of an irrevocable family trust brought an action in state court against the beneficiaries of the trust challenging the beneficiaries' alleged liquidation of a limited partnership. The Trust Protector appointed by the settlor exercised his authority to modify the governing instrument of the trust to change the procedure for removal of a trust protector. The court construed (i) a general provision permitting amendments to the manner in which beneficiaries would benefit from the trust and to the administrative provisions of the trust and (ii) a provisions permitting trust protectors irrevocably to release, renounce, suspend or modify to a lesser extent any and all powers and discretions. The court found that the two provisions do not conflict and the trust protector is not limited to modifying the administrative provisions to reduce or limit the trust protector's authority. Accordingly, the court held that the Trust Protector acted within his authority to modify the removal provisions, and because the children did not comply with the requirements, (1) the Trust Protector was not validly removed, (2) the successor trustee appointed by the trust protector appointed by the children was not validly in office, and (3) the original trustee remained in office with standing to sue the children, as co-trustees, for their actions in connection with the family partnership.

In *Minassian v. Rachins*,[460] the children of a trust's settlor brought an action against the settlor's wife, who was the beneficiary and trustee of the trust, claiming breach of fiduciary duty. The settlor's wife appointed a trust protector who, pursuant to express authority in the governing instrument, amended the trust instrument. The children challenged the validity of the amendments made by the trust protector. The children argued unsuccessfully that FTC sections 736.0410-736.04115 and 736.0412 provide the exclusive means for modifying a trust under the FTC. A similar argument was made without success by the trustee in *Peck* described above. The court finds that Section 736.0808(3) establishes a valid method to appoint a trust protector with the authority to modify or terminate the trust. Finding that the trust contained an ambiguity, the court upheld the amendment made by the trust protector which established multiple trusts upon the death of the settlor's wife for the benefit of the children. Remarkably, the court appears to conclude that the administration of the trust for the wife, which after the amendment would terminate at her death in favor of new trusts for the children, could not be challenged by the children. Thus, we find that the amendment provisions granted to the trust protector, as in *Wellin*, actually change the course of the pending litigation against the trustee. One can imagine such provisions working just as well as an *in terrorem* clause should the trust protector be granted amendment powers that can alter beneficial interests as well as make administrative changes.

H. <u>Potential Transfer Tax Consequences of a Trustee's Action to Modify by Decanting or Otherwise</u>

Can the exercise of a trustee's authority under state law or the governing instrument to effect changes to the dispositive provisions of a trust—for example, by a court approved modification, an amendment power, or decanting—have tax consequences to the beneficiaries of the trust? Although perhaps counterintuitive, if state law holds a trustee to a fiduciary standard, such that a beneficiary might object to the exercise of the trustee's discretion, more, not less, tax risk accrues. The result derives from the holding in Revenue Ruling 81-264 that sitting on your state law rights can have transfer tax consequences.[461] Suppose, for example, that the trustee engages in an exercise of discretion that diminishes a beneficiary's beneficial interest. Can the beneficiary's failure to object constitute a taxable gift? Under the gift tax law, locating the recipient of the gratuitous transfer is only necessary to diminish the property interests of the donor.[462]

The answer to the question may derive in part from the principle that to make a taxable gift, the taxpayer must engage in a voluntary action. The law imposes the gift tax to the transfer of a property interest when the donor relinquishes dominion and control.[463] Treasury Regulation section 25.2511- 2(a) provides the following:

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the

[459] 2015 WL 566486 (USDA So. Car. 2015).
[460] 152 So3d 719 (4th DCA 2014).
[461] *See* Rev. Rul. 81-264, 1981-2 C.B. 185.
[462] *See generally* Robinette v. Helvering, 318 U.S. 184 (1943).
[463] *See* Estate of DiMarco v. Comm'r, 87 T.C. 653, 680 (1986), *acq. in result* 1990-2 C.B. 1.

transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, . . . is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.[464]

The regulation confirms that, under the gift tax law, locating the recipient of the gratuitous transfer is unnecessary; only diminishing the donor's property interest is necessary. Yet, the regulation also requires an act of transfer.[465] If the act of transfer is not voluntary, meaning that the beneficiary has no legal ability to object to the transfer, then it seems that the law should not deem the transfer a taxable gift. However, suppose that the beneficiary does have the legal capacity to object. Will the failure to object constitute a taxable gift?

The answer seems to depend on the beneficiary's rights under state law. Suppose one could challenge the trustee's actions only based on a finding of abuse of discretion. *Restatement (Third) of Trusts* provides as follows:

> (1) A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee.
>
> (2) The benefits to which a beneficiary of a discretionary interest is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor's purposes in granting the discretionary power and in creating the trust.[466]

Comment *c* states that

> [i]t is contrary to sound policy, and a contradiction in terms, to permit the settlor to relieve a "trustee" of all accountability. . .[Accordingly,] words such as "absolute" or "unlimited" or "sole and uncontrolled" are not interpreted literally. Even under the broadest grant of fiduciary discretion, a trustee must act honestly and in a state of mind contemplated by the settlor. Thus, the court will not permit the trustee to act in bad faith or for some purpose or motive other than to accomplish the purposes of the discretionary power.[467]

Generally, the court will interpose if the trustee arbitrarily fails to exercise discretion, but *Restatement (Third) of Trusts* acknowledges that a settlor may manifest "an intention to relieve the trustee of normal judicial supervision."[468] In that case, a beneficiary apparently has limited ability to oppose the trustee's exercise of discretion. Additionally, perhaps the failure to oppose the trustee's exercise of discretion would fall within the scope of Treasury Regulation section 25.2512-8.[469] In particular, this would be true if the proceeding would be costly to the beneficiary who believes the likelihood of success to be minimal.

If a trust protector who is expressly not a fiduciary holds the authority to change the trust's terms, fewer tax concerns arise. Trust protectors are permitted by UTC section 808.[470] In that case, the power might appear more akin to a power of appointment, which *Restatement (Third) of Trusts* acknowledges is not subject to

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[464] Treas. Reg. § 25. 2511-2(a).
[465] *See id*.
[466] RESTATEMENT (THIRD) OF TRUSTS § 50 (2003).
[467] *Id*. cmt. c.
[468] *Id*.
[469] *See* Treas. Reg. § 25.2512-8.
[470] *See generally* Richard C. Ausness, Th*e Role of Trust Protectors in American Trust Law*, 45 REAL PROP. TR. & EST. L.J. 319 (2010).

fiduciary obligations and which, therefore, presumably cannot be opposed by a disgruntled beneficiary whose interests are diminished.[471]

Although it is unclear whether any fiduciary under a trust instrument can be exonerated from all fiduciary duties, including the duty to act in good faith, certain state statutes permit the appointment of a person able to direct actions of a trustee such that the person giving direction has no fiduciary duties.[472] Therefore, giving a power to appoint property in further trust to a person who is neither a trustee nor a beneficiary would appear to create fewer tax concerns.

I. Clues Under the GST Law

On December 20, 2000, the Treasury Department issued final regulations governing the modification of trusts that are exempt from GST tax under the effective date rules dealing with trusts that were irrevocable on September 25, 1985.[473] The regulations provide guidance on the types of modifications that will not affect the exempt status of a trust. In addition, the regulations clarify the application of the effective date rules to property transferred pursuant to the exercise of a general power of appointment.[474]

Although intended to reduce the number of applications for private letter rulings, taxpayer requests for rulings continue to abound. One reason may be the draconian effect of loss of GST tax exempt status. Although somewhat mitigated under the current rate structure, a flat tax at the highest marginal estate tax rate on each GST is substantial. Another reason may be that the regulations by their terms do not apply to trusts that are GST tax exempt by reason of an allocation of GST exemption,[475] although the Service appears to analyze both cases in the same manner."[476] Taxpayers contemplating changes to a trust that is exempt by reason either of its effective date or of an allocation of GST exemption may be unwilling to assume the risk, and trustees are particularly unlikely to proceed without certainty as to the GST tax effects.[477]

The GST regulations expressly state that GST rules apply only to determine whether a trust that is exempt by reason of its effective date retains its exempt status for GST purposes.[478] The rules do not apply to determine whether a modification results in a gift subject to gift tax, causes the trust to become includible in the gross estate of any beneficiary, or results in the realization of a capital gain for purposes of section 1001.[479]

Nevertheless, the GST regulations articulate certain principles that may have general application when analyzing the transfer tax consequences of proposed adjustments to an irrevocable trust after the adjustments take effect.

Treasury Regulation section 26.2601-1(b)(4)(i)(A) provides as follows:

> The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13 if . . . (1) [e]ither . . . (i) [t]he terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or (ii) [a]t the time the exempt trust became irrevocable, state law authorized

[471] *See* RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. a (2003).
[472] *See* Mary Clarke & Diana S.C. Zeydel, *Directed Trusts: The Statutory Approaches to Authority and Liability*, EST. PLAN., Sept. 2008, at 14.
[473] *See* Treas. Reg. § 26-2601-1(b).
[474] *See id*. § 26.2601-1(b)(1)(1).
[475] *See id*.
[476] *See* Priv. Ltr. Rul. 200839025 (May 30, 2008) (rules applicable to a trust exempt by allocation of GST exemption are no less favorable than the rules applicable to a trust exempt by reason of its effective date).
[477] *See* I.R.C. § 2603 (indicating that, in certain circumstances, the trustee may be personally liable for the GST tax).
[478] *See* Treas. Reg. § 26.2601-1(b)(4)(i).
[479] *See id*.

> distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and (2) [t]he terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. . . . [An] exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not [violate the foregoing rule].[480]

The two rules together constitute the so-called GST rule against perpetuities.

In Private Letter Ruling 201735009,[481] the trust instrument contained a measuring life provision that included certain unrelated contingent beneficiaries, who pursuant to an amendment power, were subsequently removed from the trust as beneficiaries. A beneficiary who was not living when the trust became irrevocable was added. This raised a question concerning the construction of the rule against perpetuities savings clause in the instrument. The trust was subsequently amended to preserve the original contingent beneficiaries as measuring lives consistent with the intention of the prior amendment not to alter the time for vesting. The IRS ruled that the trust remained exempt from GST tax.

The GST rule against perpetuities indicates that proceeding under authority contained in the governing trust agreement ought not to have tax consequences, provided the duration of the trust does not extend beyond the common law rule against perpetuities.[482] One should note that the need for beneficiary consent or court intervention falls outside the exception.[483] A voluntary application to court, by itself, would seem to not have adverse tax consequences.[484] But if the law requires court approval or beneficiary consent, then the power of distribution would fall outside the safe harbor of the regulation.[485]

In Private Letter Ruling 200228007, the decedent created a separate testamentary trust for each of three children.[486] The trust for Child 3 required the payment of income quarterly to Child 3 for life. The decedent's will appointed Child 1 and Child 2 as trustees with the power to make any distribution of trust principal as they thought proper and necessary for the comfort of Child 3 and her children. Upon the death of Child 3, the trust fund would pass on to her children in further trust until the trustees thought it proper to pay the trust fund to the children. Applicable state law permitted the trustees to petition for modification or termination of a trust. The state court determined that the document's reference to children referred only to natural, not adopted, children. Child 3 was seventy-three years old and the court determined that the two children of Child 3 had a vested remainder interest in the trust. The state court approved a modification terminating the trust in favor of a new trust with Child 3 as sole trustee. The new trust limited the trustee's power to distribute principal to herself to an ascertainable standard under state law. Upon Child 3's death, the new trust also required equal distribution of the assets to her children or their respective estates. The Service ruled that the modification was within the original trust instrument's authority and, therefore, did not constitute an exchange under section 1001.[487] The Service further ruled that the modification would not cause the old trust or the new trust to lose its exempt status for purposes of chapter 13.[488] Finally, the

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480 *Id*. § 26.2601-1(b)(4)(i)(A).
481 Priv. Ltr. Rul. 201735009 (May 25, 2017).
482 *See id*. § 26. 2601-1(b)(4)(i)(A).
483 *See id*.
484 *See id*.
485 *See id*.
486 *See* Priv. Ltr. Rul. 200228007 (Apr. 3, 2002).
487 *See id*.
488 *See id*.

Service ruled that none of the beneficiaries had made gifts and that the new trust would not be included in Child 3's gross estate because the distribution power was not a general power of appointment.[489]

Note that state property law determined that the grandchildren's interests vested.[490] Even though the modification reduced the standard of distribution to Child 3, the Service did not find that Child 3 had made a gift to the remainder beneficiaries.[491] This is interesting as the Service is presently unwilling to rule on the gift tax consequences of the surrender of a property interest in a discretionary trust because the value of the property interest surrendered is a question of fact.[492] Here, Child 3 would appear to have reduced the future opportunity to receive trust distributions by becoming a trustee, with the effect that future distributions would be limited to an ascertainable standard.[493] Yet, because that result derived from state law governing the trust since its inception,[494] perhaps the Service considered the reduction involuntary and thus without gift tax consequences. The distinction seems somewhat of a fine line; becoming trustee was voluntary, but the reduction in the standard of distribution that resulted was not.[495]

A separate rule deals with distributions by the exercise of a power of appointment. The exercise, release, or lapse of a power of appointment—other than a general power of appointment within the meaning of section 2041(b)—will not have adverse GST consequences if the original trust contained the power, and the holder does not exercise it in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period beyond the GST rule against perpetuities.[496] No other restriction apparently applies. Accordingly, the GST rules appear to confirm that, if exercised within its scope, a power of appointment or a power construed as akin to a power of appointment—which construction would appear to mean a power not controlled by any fiduciary obligations under *Restatement (Third) of Property*[497] —does not create transfer tax risk because the beneficiaries have no means to object to its effective exercise.[498]

A modification that resolves a bona fide dispute may also avoid adverse tax consequences. Treasury Regulation section 26.2601-1(b)(4)(i)(B) provides the following:

> A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if . . . (1) [t]he settlement is the product of arm's length negotiations; and (2) [t]he settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.[499]

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[489] *See id*.; *cf*. Priv. Ltr, Rul. 200917004 (Apr. 24, 2009) (ruling that modification to a trust agreement to include legally adopted infants or minor children in the definition of the terms *issue* and *descendants* had no GST consequences because no shift to lower generations occurred, but did have gift tax consequences to those whose interests were reduced).
[490] *See* Priv. Ltr. Rul. 2002280007 (Apr. 3, 2002).
[491] *See id*.
[492] *See* Priv. Ltr. Rul. 200243026 (Oct. 25, 2002).
[493] *See* Priv. Ltr. Rul. 2002280007 (Apr. 3, 2002).
[494] *See id*.
[495] *Cf*. Priv. Ltr. Rid. 200839025 (May 30, 2008) (holding a change of the standard of distribution to one of absolute discretion without limit to be an "increase" in the distributions to non-skip persons and thus not a shift of beneficial interests to a lower generation). Accordingly, a shift to an ascertainable standard might be considered a "decrease" depending on the circumstances.
[496] *See* Estate of Timkin v. United States, 630 F. Supp. 2d 823, 834 (N.D. Ohio 2009) (explaining lapse of a general power of appointment is a constructive addition); Estate of Gerson v. Comm' r, 507 F. 3d 435, 440 (6th Cir. 2007) (noting grandmother exercised her general power of appointment in favor of grandchildren).
[497] RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 cmt. g (2011).
[498] *See* Treas. Reg. § 26.2601-1(b)(4)(i)(A).
[499] *Id*. § 26.201-1(b)(4)(i)(B).

In Private Letter Ruling 200209007, the Service considered the modification of a testamentary trust that owned a concentration of decedent's low-yield, closely held stock.[500] The trust instrument authorized retention of investments not otherwise authorized by statute so long as the trustee deemed advisable, and the instrument directed that, if possible, the trustee hold the stock until termination of the trust.[501] All the trust's income beneficiaries had died except one who was entitled to a share of the income for life.[502] Upon the death of the surviving income beneficiary, the trustee was to divide the trust into shares for the descendants of four of the deceased income beneficiaries.[503] The surviving income beneficiary and several contingent remaindermen brought suit against the trustee to modify the trust under state law permitting modification of a trust "if the court finds that the modification will neither materially impair the accomplishment of the trust purposes nor adversely affect the interests of any beneficiary, or if made, materially benefit the trust or any beneficiary."[504] The parties sought commutation of the income beneficiary's life interest.[505] Subsequently, the state enacted a statute authorizing a trustee to make adjustments between principal and income under a prudent investor standard.[506] The income beneficiary amended its pleadings to allege "that the [t]rustee failed to invest [t]rust assets in a manner consistent with his interest as a life tenant and to apportion [t]rust receipts and expenses between income and principal in the manner required by law."[507] The contingent remaindermen opposed the requested relief.[508]

In settlement of the dispute, the parties entered into a modification agreement whereby (1) the income beneficiary's interest would be commuted for a fair price, (2) the balance of the trust would be divided into two trusts, one to distribute income to the presumptive remaindermen, determined as of each quarterly distribution, and the other to accumulate income, and (3) the contingent remaindermen who would not receive income distributions would receive a make-up distribution upon the death of the former income beneficiary.[509] The court appointed a special master who found that the modification would not materially impair accomplishment of the trust's purposes.[510] The special master also found it unlikely that the testator anticipated the deaths of five of the six income beneficiaries and the resulting accumulation of a large portion of the trust income over more than forty-one years.[511]

The Service opined that no gift tax consequences would result from a settlement based on a compromise of valid claims that reaches an economically fair result.[512] If the settlement differs from the result under state law because of competing claims, then courts must "consider whether the difference may be justified because of the uncertainty of the result if the question were litigated."[513] The Service found that the modification agreement provided a result "within the range of reasonable settlements" based on the expert opinions and the findings of the special master and of the court.[514] Accordingly, the Service ruled that the settlement created no gift tax consequences.[515]

The Service also ruled that the new trusts created by the modification agreement would continue to be exempt from GST tax because the modifications did not shift any beneficial interest to a beneficiary in a lower generation.[516]

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[500] *See* Priv. Ltr. Rul. 200209007 (Mar. 1, 2002).
[501] *See id*. at 5.
[502] *See id*.
[503] *See id*. at 5-6.
[504] *Id*. at 6.
[505] *See id*.
[506] *See id*.
[507] *Id*.
[508] *See id*.
[509] *See id*. at 7.
[510] *See id*. at 8.
[511] *See id*. at 9.
[512] *See id*. at 10.
[513] *Id*.
[514] *Id*.
[515] *See id*. at 10-11.
[516] *See id*. at 11-12.

This ruling leaves open the question of whether the taxpayer needs to satisfy both the settlement test and the "no shifting" test to avoid loss of exempt status. The regulations do not require one to satisfy both. However, if one changes the beneficiaries' interests in a manner that is tantamount to a modification because no reasonable interpretation of the governing instrument would yield the settlement result, then one must satisfy both tests. In that case, the importance of the bona fide settlement test has less to do with avoiding loss of GST exemption than it does with avoiding taxable gifts or sales or exchanges of beneficial interests that have potential income tax consequences than avoiding loss of GST exemption.

In Private Letter Ruling 201528024,[517] the beneficiaries were embroiled in extensive litigation over the application of a "Tax Charging Provision" in the governing instrument that was unclear as to the proper allocation of the capital gains tax payment as between income and principal. The parties entered into a settlement agreement which created different allocations of the tax burden in the various tax years of the trust. The IRS ruled that the settlement agreement reflected the economic values of bona fide claims of the respective parties, with appropriate allowance for litigation uncertainty. As a consequence, the parties were not treated as making taxable gifts, the trust would not lose its exempt status for GST purposes, and implementing the settlement agreement would not result in the realization of gain or loss for income tax purposes.

Nevertheless, the GST rule on settlements appears to be somewhat in conflict with the *Bosch* standard, which requires that a state court's holding be consistent with the law of the state as articulated by its highest court.[518] Perhaps what we are seeing is an unarticulated application of Treasury Regulation § 25.2512-8. If the parties to a bona fide dispute determine to settle their differences by compromising their legal positions, it seems that the law construes this as a valid business decision, not as a taxable gift resulting from a voluntary transfer.[519]

Although expressly limited to the GST effects, the GST regulations appear to provide a framework within which to analyze the tax consequences of modifications of trusts after the modifications take effect. The same general principles emerge. Authorities generally ought to respect changes permitted under the governing instrument or applicable state law. Changes to settle a bona fide dispute, even changes failing the *Bosch* standard, also may avoid transfer tax consequences to the extent the result is a reasonable compromise of the competing interests. One must carefully analyze any other changes, such as changes the interested parties agree to, to determine if the changes shift beneficial interests among the parties.

Treasury Regulation section 26.2601-1(b)(4)(D) identifies other changes that will not cause an effective date trust to lose its exempt status provided that the modification does not shift a beneficial interest to a lower generation or extend the time for vesting of any beneficial interest beyond the period provided for in the original trust. In Private Letter Ruling 201633023,[520] the original trust gave each beneficiary a right to withdraw one-half of the beneficiary's share and a limited testamentary power to appoint the share, and required a termination at the earlier of the beneficiary's death or attaining age 35. A judicial modification of the trust terms for a disabled beneficiary allowed the beneficiary's share to remain in trust for life with the same disposition upon termination, but also requiring one-half the property to be distributed to the beneficiary's estate if the beneficiary had attained age 25, and the entire trust if the beneficiary had attained age 35. The IRS ruled that the modification did not extend the time for vesting or move property to a lower generation; accordingly, the trust retained its GST exempt status.

Note that although modification of a trust instrument to alter the administrative provisions, such as powers to appoint and remove trustees, is unlikely to create tax concerns, state law may not be as generous. In *In re Trust Under Agreement of Taylor*,[521] the Supreme Court of Pennsylvania refused to permit a trust to be modified to give beneficiaries the authority to remove and replace trustees, construing section 706 of the UTC to be the exclusive provision on removal of trustees. The court held that section 706 requires the court to find that such action best serves the interests of the beneficiaries, that the removal is not

[517] Priv. Ltr. Rul. 201528024 (March 26, 2015).
[518] *See* Comm'r v. Estate of Bosch, 387 U.S. 456, 465 (1967).
[519] *See* Harris v. Comm'r, 340 U.S. 106, 109 (1950).
[520] Priv. Ltr. Rul. 201633023 (April 20, 2016).
[521] No. 15 EAP 2016, 2017 WL 3044242 (Pa. July 19, 2017), *rev'g*, 124 A.3d 334 (Pa. Super. Ct. 2015).

inconsistent with a material purpose of the trust, and that a suitable cotrustee or successor trustee is available. Granting the removal power to the beneficiaries would preempt the court's ability to ensure compliance with the foregoing standards.

X. Choosing a Trust Jurisdiction.

Changing circumstances have led to the evolution of trust laws, so that many jurisdictions now permit such modern advantages as decanting, trust merger, non-judicial settlement agreements, total return unitrusts, silent trusts, perpetual trusts, purpose trusts and pet trusts, and bifurcation of trustee functions between the trustee and a separate advisor. Decades ago, times were simpler, and settlors selected the trust department of their hometown retail bank to serve as trustee of their trust, to hold balanced portfolios of fixed income and equity securities. The local trust officer would faithfully carry out the settlor's wishes and administer the trust until its termination. Today, settlors often select a trustee in a jurisdiction far away from their residence, such as Delaware, Nevada, Alaska, New Hampshire or South Dakota to take advantage of their beneficial trust laws.[522] In addition, many existing trusts are moving to those jurisdictions. Consequently, the trustee is often selected because of its ability to administer the trust effectively and efficiently in a desirable jurisdiction.

When setting up large, complex, long-term wealth transfer vehicles for clients (which often-times is the most important thing clients will ever do for themselves and their families, and perhaps the only lasting legacy they leave), it is critical to take a quality-based approach to selecting the trust jurisdiction, and not simply gravitate toward the cheapest, most expedient option. There are many scorecards in the form of charts, comparisons and rankings that compare trust jurisdictions, often based primarily on the aggressiveness of the trust jurisdiction's statutes. However, the following factors are vitally important to consider when choosing among trust jurisdictions, and these are all questions to consider when making such a choice:

1. Ability to satisfy conflicts of law/choice of law concerns. How strong of a nexus does the trust company have the trust jurisdiction? What is the nature of the trust administration being performed in that state to satisfy conflicts of laws concerns? How clear are the conflicts of laws rules and statutes in that jurisdiction? How clear on are the courts in that jurisdiction with regard to choice of law, situs, and court jurisdiction?

2. Responsiveness and efficiency of the jurisdiction's legislature and the quality of updates. Does the jurisdiction have a long, quality-based track record of enacting new evolving trust legislation? How quickly can the state's legislature enact new legislation to take advantage of new opportunities and adapt to issues and concerns? How important is the trust industry to the state and its economic vitality?

3. Stability of the trust industry and the State's long-term commitment to the industry. How long has the jurisdiction been focused on attracting the trust industry? Is there a potential for the jurisdiction to lose focus on the trust industry and fail to keep pace? Has there been an exodus of trust companies from the jurisdiction? How strong is the commitment of major financial institutions to the jurisdiction and the trust industry?

4. Quality of the court system. What is the nature of the court that has direct jurisdiction over trust matters? How would you rate the strength and quality of the court? Could there be a jury in a trust matter? Is the court a specialized court of equity? Does the court system have a tendency to favor corporate trustees or beneficiaries, or reach unpredictable, or unprecedented holdings?

5. Quality of the judges. Are the judges elected or appointed? What is the term-length of the judges' service?

6. Depth, breadth and quality of case law. Is there sufficient case law in the jurisdiction to support stable and predictable prediction of outcomes? Have many trust issues been addressed by the court? Is there a way to publicly access court decisions to research and understand most common issues and principles?

[522] *See* Worthington & Merric, *Which Situs is Best in 2016?*, TR. & EST., Jan. 2016, at 61; Borowsky & Nenno, *A Comparison of the Leading Trust Jurisdictions*, 37 EGTJ 233 (2012).

7. <u>History and experience of the trust industry and its professional support infrastructure</u>. How much experience does the <u>jurisdiction's</u> trust infrastructure have, including its trust companies, trust offices, attorneys accountants, judges, bank commissioner, and legislature?

8. <u>Different drafting styles and trust administration practices</u>. What approaches does the trust infrastructure take to implement <u>concepts</u> such as directed trusts, decanting, court petitions, etc.?

9. <u>Quality and depth of legal counsel</u>. How many attorneys and law firms are there in the jurisdiction that specialize in sophisticated trust planning and administration? How many quality options exist?

10. <u>Variety of options among trust companies and number and diversity of high quality options, both now and in the future</u>. How many trust company options are there? Do the options among trust companies include low-priced "situs trustees", directed trustees, and large full-service trustees? How many major financial institutions have committed to servicing clients in the jurisdiction and, consequently, are vested stakeholders in the ongoing quality and viability of the trust industry? Is there a sufficient number of options if one needs to remove a trustee and appoint a successor? Are there enough trust companies to maintain commercial competitive pressure among industry practices?

11. <u>Availability and stability of experienced, high-quality, well-trained trust officers and other trust professionals</u>. Are there enough high-quality, well-trained trust officers in the jurisdiction to provide trust services for all of the trust accounts? What is the quality of the workforce?

12. <u>Taxation of trusts</u>. How does the jurisdiction tax trust income?

## XI. <u>Conclusion</u>

Planning for uncertainty in the law requires consideration of a flexibly drafted dynasty trust as a key component of any estate plan. Careful attention to the terms of the trust that permit subsequent modification or amendment is critical. Comprehensive provisions dealing with the succession of fiduciaries will also be important. Should an existing trust nonetheless prove suboptimal, the trend towards liberalization of the law on reformation and modification or irrevocable trusts may come to the planner's aid.

Rescissions, reformations, modifications, and terminations, however desirable, initially require analysis to determine the potential for adverse tax effects. Beneficial interests in trust constitute property rights under state law susceptible of gratuitous transfer with potential transfer tax consequences. Although the valuation of those rights may vary from rights that one can actuarially determine with fair certainty to rights with arguably nominal value, alterations to those rights will not escape transfer tax scrutiny. The law has developed to permit rescission of a transaction with adverse tax effects if a mistake of fact or law causes unanticipated consequences. This analysis is perhaps distinguishable from other attempts to modify a trust after creation because the availability of a remedy under state law permits one to construe the transfer as incomplete for transfer tax purposes.

In the absence of a mistake of fact or law, the analysis becomes more complex. The outcome depends on the remedy sought and the property interests of the parties prior to and after implementation of the relief. To the extent the authority to implement changes emanates from the governing instrument or from state law in effect at the time the trust became irrevocable, the primary concern will be whether the beneficiary has grounds to object and the likelihood of success in asserting the objection. If the person with authority to effectuate a change has fiduciary duties, the potential for transfer tax consequences may increase. Nevertheless, a trustee with absolute discretion will be far less susceptible to successful criticism than one with more limited authority. And defending a modification—even one achieved by consent—as being in the ordinary course of business seems possible, depending on the facts. In addition, granting an independent person, such as a trust protector, the power to amend the trust instrument can provide significant flexibility and uphold the settlor's intent in the event of a dispute.

As the tax law continues to propel the trend towards longer duration trusts and as state law provides greater opportunities to amend the terms of irrevocable trusts after creation to balance the interests and avoid excessive "dead hand" control, lawyers will need to take greater care to stay out of the danger zone.

## EXHIBIT 1

***DISCLAIMER:*** THIS DOCUMENT IS INTENDED AS SAMPLE LANGUAGE AND DOES NOT CONSTITUTE LEGAL ADVICE OR A LEGAL FORM. PLEASE DO NOT USE THE SAMPLE LANGUAGE CONTAINED HEREIN IN ANY LEGAL DOCUMENT WITHOUT PERFORMING YOUR OWN LEGAL RESEARCH REGARDING THE EFFECT OF DOING SO OR CONSULTING A LAWYER IN THE APPLICABLE JURISDICTION WHO CAN GIVE YOU THE NECESSARY ADVICE. THE AUTHORS DISCLAIMS ALL RESPONSIBILITY FOR ANY ADVERSE CONSEQUENCE THAT MAY RESULT FROM USING THE SAMPLE LANGUAGE IN ANY DOCUMENT.

## ARTICLE I

### Disposition of Residuary Trust Estate

(A) If the Settlor's Wife Survives the Settlor. If the settlor's wife survives the settlor, the trustee shall hold the following-described property as the principal of a separate trust for the primary benefit of the settlor's wife (which is referred to in this declaration as the Marital Trust):

(1) if the Federal estate tax is applicable to the settlor's estate, and if the settlor's personal representative shall make an election to qualify a portion or all of the Residuary Trust Estate for the Federal estate tax marital deduction by making the election under Section 2056(b)(7)(B)(v) of the Internal Revenue Code (which election is referred to in this Article and in Article II as the "Election"), such portion or all of the Residuary Trust Estate as to which the Election is made; or

(2) if the Federal estate tax is inapplicable to the settlor's estate, the entire Residuary Trust Estate.

(B) Administration of Marital Trust. The trustee shall, from the date of the settlor's death, pay the net income from the Marital Trust, quarter-annually or at such more frequent intervals as the trustee deems appropriate, to the settlor's wife during settlor's wife's life. The trustee is authorized, from time to time and in the trustee's discretion:

(1) to pay to the settlor's wife so much of the principal of the Marital Trust as the trustee determines for the settlor's wife's health, maintenance and support; and

(2) to pay to the settlor's wife, in addition to any amount or amounts distributable pursuant to the provisions of paragraph (1) of this Subdivision, so much of the principal of the Marital Trust for any other purpose that the independent trustee deems to be worthwhile and in the best interests of the settlor's wife.

In exercising the discretion granted to the trustee by the preceding sentence, the trustee shall have primary regard for the best interests of the settlor's wife, rather than for remainder or other successor interests.

(C) Upon the Settlor's Wife's Death. Upon the settlor's wife's death, the trustee shall:

(1) pay to the personal representative of the settlor's wife's estate any net income then on hand or accrued;

(2) unless the settlor's wife directs otherwise by the settlor's wife's will making specific reference to the Marital Trust, pay to or at the direction of the personal representative of the estate of the settlor's wife the Marginal Death Taxes, subject, however, to the apportionment provisions of Subdivision (E) of this Article;

(3) distribute the balance of the principal of the Marital Trust to or among or for the benefit of any one or more of the settlor's descendants, and on such terms and estates (including appointments in trust) as the settlor's wife appoints by written instrument executed and acknowledged by the settlor's wife (or, if the settlor's wife is unable to act, by the settlor's wife's agent acting under a duly executed power of attorney) during the settlor's wife's life and delivered to the trustee (referred to in this paragraph (3) as a "lifetime appointment"), or by the settlor's wife's last will, in each case, making specific reference to this power; provided, however, that any lifetime appointment shall be revocable by any subsequent lifetime appointment or by the settlor's wife's last will, by specific reference to such prior lifetime appointment, unless pursuant to its terms such prior lifetime appointment is specified to be irrevocable; and provided further, however, that, in the event of any inconsistency between any such lifetime appointment and a subsequent lifetime appointment or the settlor's wife's last will which is not resolved by the terms of such lifetime appointments and the settlor's wife's last will, the provisions of such lifetime appointments and the settlor's wife's last will shall be given effect in the following order of priority: first, any such lifetime appointment which pursuant to its terms is specified to be irrevocable; second, the settlor's wife's last will (regardless of whether executed before or after any such lifetime appointment); and third, any such lifetime appointment executed after any other such lifetime appointment;

(4) notwithstanding the foregoing provisions, the settlor's wife may, at any time and from time to time during the settlor's wife's life, by an acknowledged instrument in writing delivered to the trustee, release the power of appointment granted to the settlor's wife by the provisions of paragraph (3) of this Subdivision with respect to any or all of the property subject to such power and may further limit the individuals to or for the benefit of whom such power may be exercised; and

(5) if and to the extent the settlor's wife fails effectively to exercise the power of appointment granted to the settlor's wife by paragraph (3) of this Subdivision, any property not effectively appointed shall be dealt with as provided in Article III.

(D) The Election. By the settlor's will, the settlor has directed that the settlor's personal representative shall, in the exercise of the power of the personal representative to make the Election with respect to all or any portion of the property comprising the Residuary Trust Estate, make the Election to such extent, if any (and only to the extent, if any) as the independent trustee in its sole discretion directs. It is the settlor's intention to confer on the independent trustee the broadest discretionary powers with respect to the decision as to the extent the Election shall (or shall not) be made. The settlor believes that the unrestricted exercise of that discretion, free from the threat of surcharge for losses or depreciation, will, upon the whole, operate for the best interests of the trust estate, the trusts under this declaration and the beneficiaries of such trusts. To the extent that the Election is made, the settlor intends, by the provisions of this Subdivision, to obtain for the settlor's estate the advantage of the marital deduction or other similar benefit, if any, which may be available under the Federal estate tax law applicable to the settlor's estate. No provision of this declaration shall apply to the Marital Trust to the extent that its being made applicable would defeat the intent expressed in the preceding sentence. Unproductive property shall not be retained as part of the principal of the Marital Trust without the consent of the settlor's wife.

(E) Apportionment of Marginal Death Taxes. If the Marital Trust has been divided into two or more separate trusts, the Marginal Death Taxes shall be paid first from the trust or trusts, if any, having an inclusion ratio greater than zero, and, if there is more than one such trust, such taxes shall be apportioned among such trusts as the independent trustee (or, if none, the trustee), in his or her discretion, determines, but in no event shall such taxes be apportioned against any trust or portion of any trust that is not includible in the settlor's wife's gross estate for Federal estate tax purposes.

(F) Disclaimer by the Settlor's Wife. If the settlor's wife (or the settlor's wife's legal representative or agent acting under a duly executed power of attorney) makes a qualified disclaimer (within the meaning of Section 2518 of the

Internal Revenue Code) and/or a disclaimer under applicable State law of all or a specific portion of the Marital Trust, the property comprising the portion (or all) of the Marital Trust as to which the settlor's wife makes such disclaimer shall be added to and dealt with as part of the Family Trust under Article II or, if the Family Trust is not in existence, as the initial principal of the Family Trust under Article II; provided, however, that, in either case, the settlor's wife shall have no power of appointment under Subdivision (B) of Article II, whether exercisable by written instrument executed during the settlor's wife's life or by the settlor's wife's last will, with respect to the property so disclaimed.

(G) If the Settlor's Wife Does Not Survive. If the settlor's wife does not survive the settlor, the Residuary Trust Estate shall be dealt with on the settlor's death as provided in Article III.

## ARTICLE II

## Family Trust

(A) Family Trust. If the settlor's wife survives the settlor, the trustee shall, following the death of the settlor, set apart out of the trust estate and hold the following-described property as the principal of a separate trust for the primary benefit of the settlor's wife (which is referred to in this declaration as the Family Trust):

> (1) if the Federal estate tax is applicable to the settlor's estate, and if the settlor's personal representative does not make the Election as to any portion of the Residuary Trust Estate, such portion or all of the Residuary Trust Estate as to which the Election is not made; and
>
> (2) if the settlor's wife makes a qualified disclaimer,(within the meaning of Section 2518 of the Internal Revenue Code) and/or a disclaimer under applicable State law (which disclaimer, in either case, is referred to in this Article as the "Disclaimer") with respect to any portion or all of the Marital Trust, such portion or all of the Marital Trust as to which the Disclaimer is made.

(B) Administration of Family Trust. The trustee shall have the discretionary powers over the disposition of the net income and principal of the Family Trust authorized by the provisions of Article IV. On the death of the settlor's wife, the trustee shall distribute the then principal of the Family Trust, together with any net income then on hand or accrued, to or among or for the benefit of any one or more of the settlor's descendants, and on such terms and estates (including appointments in trust), as the settlor's wife appoints by written instrument executed and acknowledged by the settlor's wife (or, if the settlor's wife is unable to act, by the settlor's wife's agent acting under a duly executed power of attorney) during the settlor's wife's life and delivered to the trustee (referred to in this Article as a "lifetime appointment"), or by the settlor's wife's last will, in each case, making specific reference to this power; provided, however, that any lifetime appointment shall be revocable by any subsequent lifetime appointment or by the settlor's wife's last will, by specific reference to such prior lifetime appointment, unless pursuant to its terms such prior lifetime appointment is specified to be irrevocable; and provided further, however, that, in the event of any inconsistency between any such lifetime appointment and a subsequent lifetime appointment or the settlor's wife's last will which is not resolved by the terms of such lifetime appointments and the settlor's wife's last will, the provisions of such lifetime appointments and the settlor's wife's last will shall be given effect in the following order of priority: first, any such lifetime appointment which pursuant to its terms is specified to be irrevocable; second, the settlor's wife's last will (regardless of whether executed before or after any such lifetime appointment); and third, any such lifetime appointment executed after any other such lifetime appointment. Notwithstanding the foregoing provisions, the settlor's wife may, at any time and from time to time during the settlor's wife's life, by an acknowledged instrument in writing delivered to the trustee, release the power of appointment granted to the settlor's wife by the provisions of this Article with respect to any or all of the property subject to such power and may further limit the individuals to or for the benefit of whom such power may be exercised. If and to the extent the settlor's wife fails effectively to exercise the power of appointment granted to the settlor's wife by this Article, any property not effectively appointed shall be dealt with as provided in Article III.

## ARTICLE III

## Provisions for Descendants and Others

## ARTICLE IV

## Discretionary Powers of Trustee

## ARTICLE V

## Other Provisions Concerning Trustees

(A) Successor Trustees. The settlor makes the following designations of successor trustees of the trusts created under this declaration: ________________________________.

(B) Appointment of Additional or Successor Trustees. Additional or successor trustees may be appointed at any time or times (1) by the settlor or (2) if the settlor is not living or able to act, by the settlor's wife or (3) if the settlor's wife is not living or able to act, with respect to any particular trust, by the individual or individuals from time to time in office as trustees of that trust or (4) if no individual is in office as trustee of a particular trust, by the individual or individuals from time to time in office as trustees under this declaration; provided, however, that, if (i) the settlor's wife survives the settlor, (ii) the Federal estate tax is applicable to the settlor's estate, and (iii) there shall be no independent trustee serving under this declaration during any time when the Election may be timely made, the individual or individuals from time to time in office as trustees under this declaration shall promptly appoint an independent trustee to serve as an additional trustee under this declaration. The individual or individuals authorized to appoint additional or successor trustees (i) may determine the order of succession, (ii) may designate any contingency upon which any appointment is to take effect and (iii) may revoke any such appointment until it takes effect by its terms.

## ARTICLE VI

## Definitions

(A) Applicability of Estate Tax. For purposes of this declaration:

(1) the Federal estate tax shall be deemed to be "applicable to the settlor's estate" if and to the extent that the provisions of Subchapter A of Chapter 11 of Subtitle B of the Internal Revenue Code are in effect at the settlor's death and applicable to the settlor's estate, including by virtue of an election to that effect duly made by the personal representative of the settlor's estate or other person authorized by law to act on behalf of the estate; and

(2) the Federal estate tax shall be deemed to be "inapplicable to the settlor's estate" if and to the extent that the provisions of Subchapter A of Chapter 11 of Subtitle B of the Internal Revenue Code are not in effect at the settlor's death or are inapplicable to the settlor's estate, whether by election, non-election or otherwise.

(B) Internal Revenue Code and Treasury Regulations. Any reference in this declaration to a Subchapter, Chapter, Subtitle or Section of the Internal Revenue Code or a Section of the Treasury Regulations shall be deemed to refer to that subchapter, chapter, subtitle or section of the Internal Revenue Code of 1986 or section of the Treasury Regulations promulgated thereunder as in effect on the date of this declaration, or to the corresponding provisions of any subsequent Federal tax laws and regulations which shall be in effect at the relevant time.

(C) Marginal Death Taxes. For purposes of this declaration, the term "Marginal Death Taxes" means such amount as the settlor's wife's personal representative determines to be equal to the amount, if any, by which the total of all estate, inheritance and succession taxes (including any interest and penalties relative thereto) payable by reason of the settlor's wife's death are greater than such taxes would have been if no part of the principal of the Marital Trust had been required to be taken into account in the determination of such taxes. The trustee is entitled to rely conclusively and act upon any statement rendered to him by the personal representative of the estate of the settlor's wife concerning the amount of any such payment or the time at which, or the governmental authority or other person or entity to which, it shall be made.