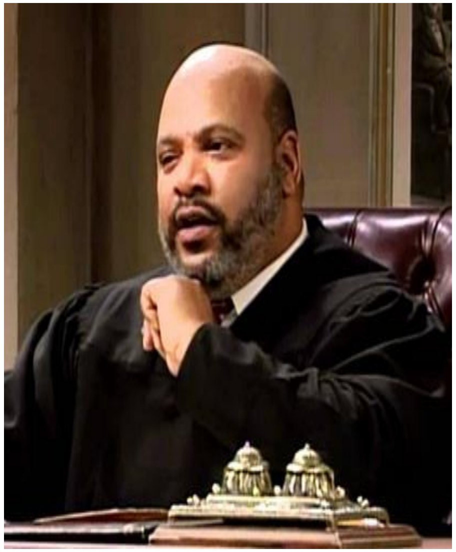
Changing Irrevocable Trusts: An Analysis of Methods and Tax Consequences

Lauren Y. Detzel
February 6, 2019

Case Study #1:
Severance & Modification of Trusts

Phil dies survived by his wife, Vivian, his son, Carlton, and his (adopted) son Will. Phil leaves a credit shelter trust that provides for discretionary distributions to Vivian for HEMS during her lifetime and upon her death, it splits into separate dynasty trusts for Carlton and Will.



Assume the Credit Trust owns $1 million of securities, $2 million of rental properties, and a 100% interest in a family dance studio business (that Carlton now manages) valued at $2 million. Carlton, being a gifted businessman and dancer, expects to double the value of the dance studio over the next 5 years, now that he is in control and can teach the dance moves that he wants to.

Carlton hates the idea that his efforts to enhance the business could benefit Will and Will’s descendants in the future.

Will thinks Carlton is a disaster and Will wants nothing to do with the business.

Upon Vivian’s death, there is sure to be a fight between Will and Carlton regarding the division of the Trust assets, primarily due to the growth or decline of the business.

However, during Vivian's lifetime, Will and Carlton will certainly cooperate because they want an inheritance from Vivian.

What can be done to save the Banks family?

Proposed Solution

Sever and modify the Credit Trust into 2 Trusts.

- Trust 1 will be for the benefit of Vivian for life, with a remainder to Will in trust.
- Trust 1 will own the rental properties ($2,000,000) and $500,000 of securities.
- Trust 2 will be for the benefit of Vivian for life, with a remainder to Carlton in trust.
- Trust 2 will own the interest in the family business ($2 million) and $500,000 of securities.
- The remaining terms of the Trusts will be identical to the Credit Trust.

Benefits of Severance and Modification

- Each Trust has assets worth $2.5 million
- Only Vivian, Carlton and his descendants will share in the success or failure of the business. The share for Will and his descendants is not affected by the performance of the business.
- Each Trust has assets that, with Vivian's consent, can be independently invested without the consent of the other child.
- Agreement can be made between Vivian, Will and Carlton that distributions for Vivian will be made equally from Trust 1 and Trust 2.

Options to Accomplish Severance and Modification

Severance

- F.S. § 736.0417 - Permits severance of a trust after notice to qualified beneficiaries if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trusts. Effective date may be retroactive and doesn't require all trusts to have identical terms
- Trust Agreement can provide for severance of division without notice to beneficiaries

Options to Accomplish Severance and Modification (cont.)

Nonjudicial Modification

- F.S. § 736.0412 - Unanimous agreement of trustee and all qualified beneficiaries. Doesn’t apply to trusts created before 1/1/2001 or trusts created after 12/31/2000 if trust must vest in the “90 year” RAP unless the trust specifically provides for nonjudicial modifications.

- F.S. § 736.04117 – Decanting. 60-day notice required. See new decanting statute.

Options to Accomplish Severance and Modification (cont.)

Judicial Modification

- F.S. § 736.04113 – Court may modify an irrevocable trust if:
  1. The purposes of the trust have been fulfilled or have become illegal, impossible, wasteful or impractical to fulfill;
  2. Because 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
  3. A material purpose of the trust no longer exists.

Options to Accomplish Severance and Modification (cont.)

Judicial Modification

- F.S. § 736.04115 - Modification for best interests of beneficiaries. Doesn't apply to trusts created before 1/1/2001 or trusts created after 12/31/2000 if the trust provides for the 90 year RAP

Funding of Trust 1 and Trust 2

- Pro rata funding permitted
- Non-pro rata funding permitted under the terms of the trust or, if not, under state law. F.S. § 736.0816(22)

Trustee Liability

- Releases from all interested persons (if nonjudicial) or court approval (if judicial modification)
- Virtual representation (if minors)

<u>Income Tax Issues</u>

Concern: The exchange of interests by Will and Carlton could be treated as a sale or exchange under IRC § 1001, which could result in gain or loss to Will and Carlton to the extent the amount realized exceeds basis.

Treasury Regulation § 1.1001-1(h)

- The <u>severance</u> of a trust is not an exchange of property for other property differing materially in either kind or extent if (1) the severance is permitted by the trust or state statute, and (2) any non-pro rata funding is authorized by state law or the trust terms.
- If non-pro rata funding is prohibited, but is used anyway, then it will be treated as pro rata funding followed by an exchange of assets between the trusts, which is taxable.

Income Tax Issues (cont.)

Landmark case: *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991)

- Test: Exchange of interests results in a disposition under IRC § 1001 only if the interests exchanged are "materially different in kind or extent."

- Compare the legal entitlements before and after the modification.

- This test has been applied by the IRS in numerous PLRs when analyzing whether a trust modification will be a taxable disposition by beneficiaries for income tax purposes.

Gift Tax Issues

Concern: Will and Carlton could be treated as making a gift to each other by relinquishing their beneficial interest in the other's trust.

Gift will be deemed to be made to the extent the modification shifts value from one beneficiary to the other.

If a bona fide dispute/litigation exists, then a settlement resulting from the dispute should be treated as a transfer for full and adequate consideration and, thus, not a gift for gift tax purposes.

- *Ahmanson Foundation v. U.S.*, 674 F.2d 761 (9th Cir. 1981) – Intrafamily settlements will not be regarded as a bona fide compromise unless the claims were legitimate and are satisfied, to the extent feasible, on an economically fair basis.

GST Tax Issues

Concern: The creation of two new trusts could cause the loss of GST exemption that was allocated to the Credit Trust upon Phil's death.

Preserve GST upon Severance – Treas. Reg. § 26.2642-6 Qualified severance

- Pursuant to state law or trust terms;
- Effective under local law;
- Funding must occur within 90 days of severance date;
- Resulting trusts must provide in the aggregate for same succession of interests of beneficiaries as the original trust. Regs provide that this may be satisfied in certain cases where a trust for multiple beneficiaries is divided into separate trusts along family lines; and
- The severance must not extend the time for vesting of any beneficial interest beyond the period provided for in (or applicable to) the original trust.

GST Tax Issues (cont.)

Preserve GST upon Modification – Treas. Reg. § 26.2601-1(b)(4)(i)(D)

- Modification may not:

  (i) shift a beneficial interest in the trust to a lower generation than those who held interests prior to the modification.

  - shift occurs if there is either an increase in the amount of a GST transfer or the creation of a new GST transfer. A modification to administrative provisions that indirectly increases a GST transfer will not be treated as a shift of a beneficial interest to a lower generation.

  (ii) extend the time for vesting of any beneficial interest beyond the period provided for in the original trust.

GST Tax Issues (cont.)

If the modification is done to resolve a bona fide dispute, adverse tax consequences may also be avoided. Treas Reg. 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) The settlement is a product of arms length negotiations; and

GST Tax Issues (cont.)

(2) The 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.

Although this is a GST regulation it presents a good analogy for the application of other possible taxes involved in the settlement of a bona fide dispute.

Case Study 2 - Termination of Trust: QTIP Trust Settlements

The Tale of

Mone Baggs $mith

Meet Mone Baggs $mith

In 2012, at the age of 89, the Texas oil tycoon married a woman named Vanna Nicole who, at 26, was 63 years his junior!

‘Til Death Do Us Part

- Shortly after their marriage, Mone died and Vanna became the beneficiary of a $45,000,000 QTIP Trust established by Mone

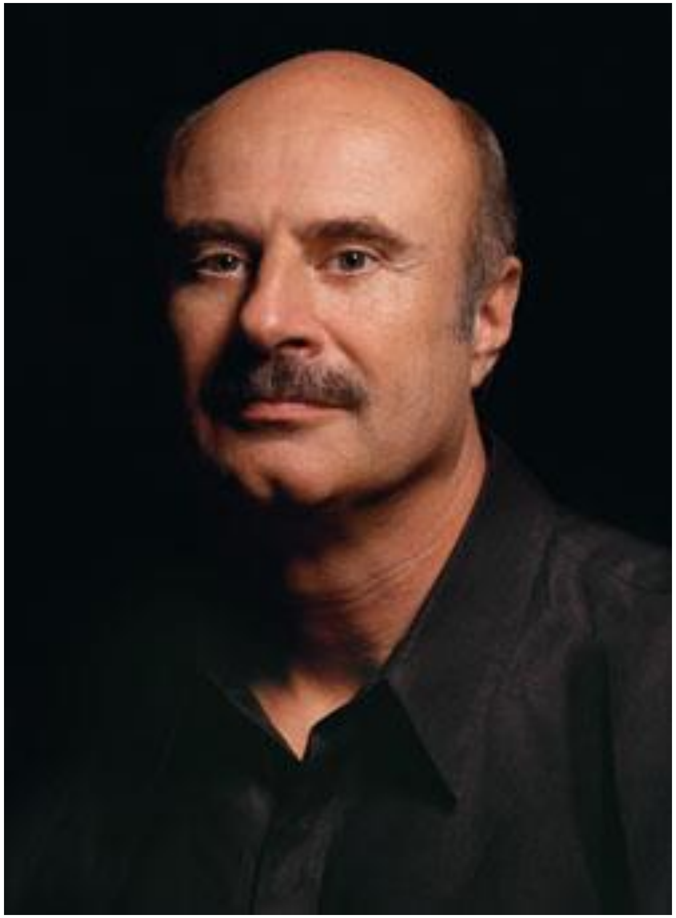
- QTIP Trust pays Vanna all income for life, remainder to Mone’s children (who are 30 years older than her), if living

Vanna Nicole - A Happy Woman

$mith Children, NOT SO MUCH

Disagreements ensue about everything (investments, income distributions, Trustee commissions, administration expenses, etc.)

Problem-Solving Trustee



- Trustee engages attorneys to terminate QTIP Trust under Florida Trust Code using a nonjudicial modification. 736.0412

- Requires unanimous consent of all qualified beneficiaries

Scenario 1

- Vanna receives distribution equal to the value of her life income interest based on §7520 rate (Jan. 2019 = 3.4%) and her current age (she is now 28); i.e., approximately 79%

- Mone's children receive the remainder of the QTIP Trust; i.e., approximately 21%

Scenario 1

- Vanna has no assets of her own and has never made any taxable gifts
- Mone used all of his available exemption (i.e., none was portable to Vanna)
- What are the gift, estate and income tax consequences of the termination of the QTIP Trust?

Scenario 1

- Vanna receives $35,523,900 for her life income interest
- Vanna makes a Section 2519 gift of the remainder interest ($9,476,100) in the QTIP Trust to Mone's children. PLR 200844010
- Section 2519 gift will be a "net gift" for tax purposes because §2207A provides for recovery of gift tax from QTIP remainder. Gift tax will only be due, however, if gift exceeds Vanna's remaining exemption.

Scenario 1

Estate tax consequences:

1. Vanna loses her estate tax exemption to offset taxes at her death
2. If Vanna dies within 3 years of the termination, Section 2035(b) brings gift tax paid back into Vanna's estate for estate tax purposes. *Estate of Anne Morgens v. Commissioner*
   - consider indemnity agreement from remainder beneficiaries or life insurance to cover the risk

Scenario 1

Income tax consequences to Vanna:

1. Vanna is treated as having received the value of the life interest in exchange for the sale of her entire interest in the Marital Trust. *McAllister v. Comm'r.*
2. Vanna has zero basis in her interest in the Marital Trust, therefore, entire amount received is gain. §1001(e); Treas. Reg. §1.1001-1(f)
3. Treated as amount realized from sale of a capital asset. *McAllister; Rev. Rul. 72-243*
4. Capital gain would be long-term because the termination was more than one year after Mone's death
5. Vanna's income tax basis in the assets she receives is equal to their fair market value. §1012

Scenario 1

- Income tax consequences to QTIP Trust:

1. QTIP Trust does not realize any gain. PLR 200723014
2. Unless appreciated assets are distributed to Vanna. §1001; §1.661(a)-2(f)

- Income tax consequences to $mith children

1. Tax on any capital gain realized by Marital Trust paid from remainder interest, reducing payout to children
2. Children receive carryover basis in assets received. §643(e)

Scenario 2

How would the gift tax consequences change if Vanna agrees to receive less than the §7520 value of her life income interest?

Scenario 2

Vanna now makes 2 gifts:

1. §2519 gift is same
2. §2511 gift = §7520 value less amount received

- Annual exclusion available
- No §2207A "net gift"

Scenario 3

How would the gift tax consequences change if the children agree to receive less (but not $0) than the §7520 value of their remainder interest?

Scenario 3

- Same §2519 gift by Vanna
- Children make gifts to Vanna equal to value of §7520 remainder interest less amount received. PLR 199908033

Case Study #3: Decanting

Camille created a Florida irrevocable trust in 2002 that provides for distributions to or for the benefit of Sarah, and Sarah's descendants, for health, education, maintenance and support. In addition, a disinterested trustee may make distributions for Sarah and Sarah's descendants for their best interests.

The Trust provides that 1/3 of the Trust assets shall be distributed to Sarah once she reaches age 35, 1/2 shall be distributed to Sarah once she reaches age 40, and all remaining assets shall be distributed to Sarah once she reaches age 45. If Sarah dies prior to receiving all of the Trust assets, then the balance is distributed outright to Sarah’s descendants, per stirpes.

Sarah has two adult descendants, Amber and Drew.

Camille did not allocate any GST exemption to the Trust.

The Trust assets have grown larger than Camille anticipated and she does not want Sarah or her descendants to receive a large distribution of the Trust assets outright at any age because Camille's new advisor has explained to her the benefits of trusts.

She has concerns that Sarah, Amber and Drew may lose the motivation to "make something of themselves" if they receive a lump sum distribution from the Trust.

What can be done to save the Braverman family?

State Law Issues

- In total, at least 21 states have a decanting statute, each with their own requirements (Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, and Wyoming).

- Florida
  - *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (1940)
  - F.S. § 736.04117 – Trustee's Power to Invade Principal in Trust
    - Statute was substantially revised March 19, 2018
    - What if a beneficiary objects?
    - What about the Trustee's liability?

New F.S. § 736.04117

- Updated after consideration of Uniform Decanting Act and decanting laws of other states.
- Trustee is now permitted to decant based on an absolute power or a power that is limited by an ascertainable standard (i.e., HEMS).
  - The changes that may be accomplished through a decanting vary depending upon whether the trustee decants pursuant to an absolute power or an ascertainable standard
- Adds explicit authority for trustee to decant assets to a supplemental needs trust.
- Expands notice provisions to require a copy of the second trust to be provided.
- Updates decanting pursuant to an absolute power to address vested interests and powers of appointment.

IRS Guidance

- IRS Notice 2011-101 (December 21, 2011) – IRS requested comments regarding the circumstances under which transfers by a trustee of all or a portion of the principal of one irrevocable trust to another irrevocable trust that result in a change in the beneficial interests in the trust are not subject to income, gift, estate or GST taxes.

- IRS has yet to issue final guidance and will not issue private letter rulings in the meantime.

Grantor Trust / Income Tax Issues

- Generally, the grantor of the first trust will remain the grantor of the second trust. Treas. Reg. § 1.671-2(e)(5). However, if decanting is done pursuant to an exercise of a general power of appointment, then the person exercising the general power will become the grantor of the second trust.
- Generally, the rules of Subchapter J should apply so that a distribution from a complex trust will carry out DNI to the second trust. Treas. Reg. § 1.643(c)-1. But if the terms of both trusts are substantially similar then the second trust is just a continuation of the first trust and so no carryout of DNI. Second trust should succeed to all the tax attributes of the first trust.

Grantor Trust / Income Tax Issues

- Decanting from grantor trust to grantor trust = should not be an income tax event. Rev. Rul 85-13.
- Decanting from a non-grantor trust to grantor trust = should not be an income tax event. See Chief Counsel Advice 200923024.
- Decanting from a grantor trust to non-grantor trust = possible income tax event. See *Madorin v. Commissioner*, 84 T.C. 67 (1985); Treas. Reg. 1.1001-2(c), Ex. 5.

Two exceptions to the above: **(1)** transfer of appreciated assets from a domestic trust to a foreign non-grantor trust; and **(2)** if the trust holds property that has debt in excess of basis or a partnership with a negative capital account.

Grantor Trust / Income Tax Issues (cont.)

- Decanting from a non-grantor trust to non-grantor trust = Possible income tax event. See *Cottage Savings Assn. v. U.S.*, 499 U.S. 554 (1991); PLR 200736002.

- However, one principal argument that the decanting should not be an income tax event to the beneficiaries is that the decanting is pursuant to the exercise of a trustee's power under state law. It is not an action by the beneficiaries. If the Trustee is authorized under state law or the trust document to decant, then the beneficiaries generally do not have the legal authority to prevent the decanting and thus, should not be treated as selling or exchanging their beneficial interest.

Gift Tax Issues

A. Decanting by a Trustee who is NOT a beneficiary
  - Generally not a gift because it's pursuant to a Trustee's exercise of a discretionary trust
  - However, if the trust document or state law requires beneficiary consent to the decanting and beneficiary consents to the decanting and the beneficiary's interest is reduced, then may be a gift by the beneficiary.
  - Receiving notice should have no effect.
  - Even if beneficiary whose interest is reduced consents or releases the trustee, the beneficiary shouldn't be deemed to make a gift as long as the decanting could have been effectuated by the Trustee without the beneficiary's consent.

Gift Tax Issues (cont.)

B. Decanting by a Trustee who is a beneficiary

- If a Trustee who is also a beneficiary exercises a decanting power in a manner that decreases his beneficial interest, he may have made a taxable gift to the other beneficiaries.

- If the interest of the trustee-beneficiary in the first trust is discretionary, the decanting may not result in a taxable gift because the trustee-beneficiary has no enforceable right to distributions from the first trust.

Estate Tax Issues

Identity of the Transferor

- If there is no gift, the transferor for federal estate tax purposes of the second trust is the person who transferred assets to the first trust
- If decanting results in a gift, then the beneficiary who is deemed to have made the gift should be considered to be the transferor of the second trust for federal estate tax purposes to the extent of the transfer.

Estate Tax Issues (cont.)

Estate Inclusion

- Generally the estate tax treatment of the second trust will be the same as the first trust (if inclusion of first trust there will be inclusion of second trust and vice versa)

- But if the transferor is given a power in the second trust by the decanting that he didn't have in the first trust then assets of the second trust could be included in the transferor's gross estate under §2038 or §2042 (if insurance is involved).

GST Issues

Assume the Trust did not have mandatory distributions once Sarah reached ages 35, 40 and 45, but instead provided for assets to remain in trust for Sarah's lifetime and, upon her death, pay outright to Sarah's descendants, per stirpes. Assume further that the Trust was exempt from GST tax prior to the decanting. Can the Trust be decanted without losing the GST exemption?

- The IRS has stated in non-binding private letter rulings that, at a minimum, a change that would not affect the GST status of grandfathered GST exempt trusts would similarly not affect the exempt status of trusts that are exempt as a result of an allocation of GST exemption. PLR 200839025; 200822008.

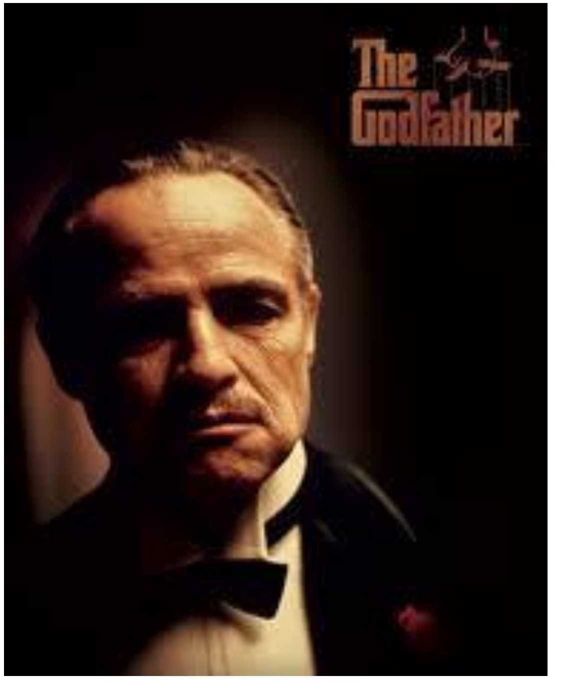
GST Issues (cont.)

Treas. Reg. § 26.2601-1(b)(4)(i)(A) - Safe Harbor Requirements to Preserve Exempt Status for Grandfathered Trusts:

1. Either the terms of the trust authorize decanting without the consent of any beneficiary or court, or at the time the exempt trust became irrevocable, state law authorized decanting without the consent of any beneficiary or court; and
2. Terms of the second 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 or absolute ownership of an interest, measured from the date the first trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years.
    - Postponing or suspending the vesting or absolute ownership of an interest for a term of years that will not exceed 90 years is expressly permitted.

Case Study #4:
Use of Trust Protector to Modify Trusts

Tony funds a Florida irrevocable discretionary trust for the benefit of his kids, Meadow and Anthony, and their descendants, with interests in the family business and cash. He names Carrado as Trustee. Tony believes maintaining the family business interests will offer the best investment return for his heirs. He has some concerns, however, that after his death, Anthony may try to pressure Corrado to “cash out” of the family business and make large cash distributions from the trust to Anthony.



As a safeguard, Tony appoints his business acquaintance Vito as Trust Protector.

As Trust Protector, Vito is granted the authority to (1) remove and replace any trustee, (2) add or remove beneficiaries to the trust and (3) amend or modify the trust to correct ambiguities or carry out the settlor's intent.

Tony blacks out and dies while eating a meal at a local diner. Later, Vito catches wind of Anthony's plan to try to influence Corrado to cash out of the family business.

Vito cannot solve the problem the way he usually would because Anthony is Tony’s son. He is, however, interested in using his Trust Protector powers as a means to work out the situation.

What can Vito do and what consequences might there be?

Validity of Trust Protector Powers

- Vito could remove Corrado as Trustee and name someone that will not bend to Anthony’s wishes.
- But this would be a temporary fix as Anthony could object to accountings and try to force a sale of the business in court.
- So Vito decides to remove Anthony as a beneficiary entirely, leaving Anthony’s children in as trust beneficiaries.
- Anthony challenges the Trusts Protector's actions. Will the court uphold the removal of Anthony as a beneficiary?
- Clearly, whether a court in Florida will uphold his action will depend on the wording of the trust and the Trust Protector’s ability to prove Tony’s intent.

Minassian v. Rachins
152 So. 3d 719 (4th DCA 2014)

Husband died leaving a trust primarily for the benefit of the wife. He was concerned that the children (especially an estranged daughter) would object to the wife's handling of the trust. So he authorized the wife to appoint a Trust Protector who would have the power in the sole and absolute discretion of the Trust Protector to amend or modify the trust provisions to:

1) Correct ambiguities that might require court construction or

2) Correct a drafting error that defeats the husband's intent.

Minassian v. Rachins (cont.)

The trust required the Trust Protector to determine husband's intent and consider the interests of current and future beneficiaries as a whole and to amend only if the amendment will either benefit the beneficiaries as a group (even though particular beneficiaries may thereby be disadvantaged) or further the husband's possible wishes in an appropriate way.

The wife appointed the husband's estate planning attorney as the Trust Protector in the middle of litigation brought against the wife by the children. The Trust Protector exercised his powers in a way to favor the wife in the litigation and allow her to manage the trust without interference from the children in the future.

Upon challenge of the Trust Protector's authority and actions by the children, the 4th DCA upheld the validity of the concept of the Trust Protector in general and the exercise of his particular actions.

The 4th DCA said that § 736.0808(3) of the Florida Trust Code specifically provides for the appointment of a Trust Protector with powers to modify the terms of the trust.

Things to Consider:

1) Are the powers given to a Trust Protector fiduciary powers? Should they be?

2) Can the Trust Protector be totally exculpated from liability for the exercise / non-exercise of powers?

3) Can a Trust Protector be used to effectively get around the prohibition on in terrorem clauses?

4) What are the tax consequences of modifications to trusts accomplished pursuant to the exercise of a power by a Trust Protector?