CHANGING THE UNCHANGEABLE: MODIFYING IRREVOCABLE TRUSTS BY REFORMATION, CONSTRUCTION, DECANTING AND EARLY TERMINATION

By

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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. 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. An increased desire to achieve asset protection through the use of trusts may also be responsible for the increased use of long-duration irrevocable trusts. Yet drafting a long-term irrevocable trust is a challenging undertaking for the draftsperson. During the continuation of the trust, the law, the circumstances of the trust beneficiaries, or both may change in a way that was not foreseen or considered when 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. 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.
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 to make changes to the administrative and dispositive provisions of an irrevocable trust. 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.

II. A REFRESHER ON THE LAW OF FUTURE INTERESTS

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. 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

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7 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).
8 Changes to irrevocable trusts can also have income tax consequences, but those effects are beyond the scope of this paper.
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.¹⁰ Most states now allow, either by statute or case law, for the transfer of contingent remainders during life¹¹ and for the passing of vested remainders to the estate of the beneficiary, assuming they are not subject to a condition subsequent.¹²

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.¹³ 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 will or the laws of intestacy would dispose of it.¹⁴

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.¹⁵

Interestingly, whether an interest is vested subject to divestment and therefore descendible continues to be the subject of litigation. In *In re DiBiasio*,¹⁶ the decedent created a testamentary trust to provide for the care and support of his surviving siblings.¹⁷ Upon the death of the last surviving sibling and following the payment of certain cash gifts, the trustee was to

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¹¹ 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.").

¹² 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).


¹⁴ See infra text accompanying notes 79-92.

¹⁵ See sources cited supra note 10.


¹⁷ See id. at 973.
distribute the remainder to the decedent’s nephew. 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. Accordingly, the interest passed to the nephew’s children.

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*, 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. 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. 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.

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.

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

The 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, \textit{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.\footnote{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).}

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 \textit{United States v. Land},\footnote{303 F. 2d 170 (5th Cir. 1962).} 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 \textit{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.\footnote{Id. at 172.}

The property law principles governing a particular interest will impact its transfer at the time of decedent's death. In \textit{Pierre v. Commissioner},\footnote{133 T.C. 24 (2009), supplemented by Pierre v. Comm’r, 99 T.C. Memo. 2010-106, 99 T.C.M. (CCH) 1436.} 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 well established that the
Internal Revenue Code creates "no property rights but merely attaches consequences, federally defined, to rights created under state law."\(^{31}\)

In *Morgan v. Commissioner*,\(^{32}\) 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.\(^{33}\) 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*,\(^{34}\) 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."\(^{35}\)

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.\(^{36}\)

An interest in property would appear to include any interest, even one that is contingent. Section 2033\(^{37}\) 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."\(^{38}\) 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.\(^{39}\)

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."\(^{40}\) 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

\(^{31}\) See id. at 29 (quoting United States v. Nat'l Bank of Commerce, 472 U.S. 713, 722 (1985) (internal quotation marks omitted)).

\(^{32}\) 309 U.S. 78 (1940).

\(^{33}\) See id. at 80-82.

\(^{34}\) 115 T.C. 506 (2000).

\(^{35}\) *Id.* at 513 (citing Nat'l Bank of Commerce, 472 U.S. at 722).

\(^{36}\) *Pierre*, 133 T.C. at 30-31, 36.

\(^{37}\) 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.

\(^{38}\) I.R.C. § 2033.


\(^{40}\) I.R.C. § 2001(a).
death—for example, if it is a contingent remainder interest with an unsatisfied condition—no estate tax is imposed.\textsuperscript{41} 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 $A$.\textsuperscript{42} Thus, if $B$ dies before $A$, no portion of the trust estate is included in $B$'s gross estate under section 2033.\textsuperscript{43} 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 $A$.

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.\textsuperscript{44} 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.\textsuperscript{45} 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."\textsuperscript{46} 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.


\textsuperscript{43} See id.; I.R.C. § 2033.

\textsuperscript{44} See, e.g., Crowley v. Engelke, 68 N.E. 2d 241, 273 (Ill. 1946).


\textsuperscript{46} Id. at 324.
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.47

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,48 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 Florida’s antilapse statute.49 The spouse’s adopted son killed the settlor and spouse, and the probate court deemed their deaths to be simultaneous.50 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.51 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.52

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.53 The ruling states that, in general, future interests in property that a decedent owns at death are taxed just like possessory interests.54 Thus, the value of a vested remainder interest is includible in the value of a remainderman’s gross estate under section 2033, even though the remainderman dies before obtaining possession of the property.55

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

47 Id. at 325.
49 See id. at 17.
50 See id. at 17-18.
51 See id. at 17 (citing Travis v. Ashton, 23 So. 2d 725, 727 (Fla. 1945)).
52 See id. (citing Fla. Nat’l Bank of Palm Beach Cnty. v. Genova, 460 So. 2d 895, 897 (Fla. 1984)).
54 See id.
55 See id.; I.R.C. § 2033.
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. 56

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. 57

B. For Gift Tax Purposes

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. 58

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. 59

Under section 2051, taxable estate means the value determined by the deductions from the value of the gross estate. 60 Gross estate, in turn, means the value at the time of death of all the decedent's property. 61 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. 62

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 may be undefined and that a transfer may be implied based upon a

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57 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).
60 I.R.C. § 2001(a).
61 See I.R.C. § 2051.
62 See I.R.C. § 2031(a).
loss in value to the property interests that the donor held. Treasury Regulation section 25.2511-1(c) 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.

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.

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.” 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. 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.”

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.” This means that the exercise would not diminish a property interest held in the trust by the powerholder and that the power is not a general power of appointment within the meaning of section 2514.

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64 See Treas. Reg. § 25.2511-2
65 Id. § 25.2511-1(e).
66 Id. § 25.2511-1(f)
67 Id. § 25.2512-1.
68 See id. § 25.2512-8.
69 Id.
70 Id. § 25.2702-2(a)(2).
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—the law will likely assign the interest a zero value, transferring the entire interest held. The law could potentially measure the transfer by either the loss of value to the donor or the tax consequences of holding that interest.

In *Smith v. Shaughnessy*, 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." 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. The dissent sought to frame the question in terms of whether the reversion negated the gift's completion until the donor relinquishes the interest, but the majority was satisfied to rely on the appropriate actuarial computations.

In *Commissioner v. Wemyss*, 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." 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." 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)."

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. The Treasury

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71 See I.R.C. § 2702.
72 318 U.S. 176 (1942)
73 Id. at 180.
74 See id. at 181.
75 See id. at 183 (Roberts, J., dissenting).
76 See id. at 178 (majority opinion).
77 324 U.S. 303 (1945).
78 Id. at 307.
79 Id. at 306.
80 Id.
81 See I.R.C. § 2511(a).
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. Courts have extended this rule to instances in which the taxpayer fails to enforce legal rights. For example, in *Lang v. Commissioner*, 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. 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.

In *Jewett v. Commissioner*, 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 encompass[ed] an indirect transfer, effected by means of a disclaimer, of a contingent future interest in a trust.” 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.” The Court’s holding conflicted with the decision of the U.S. Court of Appeals for the Eighth Circuit in *Keinath v. Commissioner*, 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. 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,” and rejected *Keinath*’s reasoning, finding that the disclaimer was not timely and that the property disclaimed was therefore subject to gift tax. 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. In addition, a transferor chooses the recipients of the transfer, but a disclaimer can make no such selection. 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. 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. 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.

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." 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." The amount of the gift will be "the principal amount forgiven and the interest accrued to the date of the forgiveness." General Counsel Memorandum 38,584 states that Revenue Ruling 81-264 based its conclusion on Estate of Lang v. Commissioner, 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. Thereafter, the debtor, not the creditor, decides whether and under what terms to repay loaned funds. 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. "That control is transferred by a statutory mechanism rather than an overt donative gesture is not significant." 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.

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96 See id.
97 Id.
99 Id.
101 64 T.C. 404 (1975), aff'd in part, rev'd in part, 613 F. 2d 770 (9th Cir. 1980).
103 See id. at 773 (citing Smith v. Shaughnessy; 318 U.S. 176, 181 (1943)).
104 Id.
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.\textsuperscript{106}

In \textit{Harris v. Commissioner},\textsuperscript{107} 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.\textsuperscript{108}

In \textit{Harris}, the property given to the husband greatly exceeded the value of the property received by the wife.\textsuperscript{109} 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).\textsuperscript{110}

However, the \textit{Harris} holding might have been dependent on court approval of the property division. In Revenue Ruling 68-379, the Service seems to depart from \textit{Harris}.\textsuperscript{111} 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."\textsuperscript{112} 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."\textsuperscript{113} Although superceded by section


\textsuperscript{107} 340 U.S. 106 (1950).

\textsuperscript{108} Id. at 112.

\textsuperscript{109} See id. at 109.

\textsuperscript{110} 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.").


\textsuperscript{112} Id. at 414.

\textsuperscript{113} Id.
2516,114 the ruling casts some doubt on the extent to which Harris supports an ordinary course of 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.115

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.116 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.117

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.118 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.”119 The settlor’s spouse also appears to have had a discretionary interest in trust principal.120 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.”121 The settlor’s spouse also had a testamentary power of appointment among the settlor’s lineal descendants.122 The spouse proposed to exercise his inter vivos power of appointment in part to appoint a trust for the benefit of his grandchildren.123 The trust was otherwise exempt from the GST tax.124 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.125 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 13.126 The spouse, therefore, is deemed to have made direct skip transfers to the trusts for grandchildren.127

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

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114 See I.R.C. § 2516.
115 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).
117 See id. at 343.
118 See Priv. Ltr. Rul. 200243026 (July 24, 2002).
119 Id.
120 See id.
121 Id.
122 See id.
123 See id.
124 See id.
125 See id.
126 See id.
127 See id.
trustee to invade corpus for the benefit of others." 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. The second decedent had an income interest in the trust. The Service established that the trust anticipated corpus invasions for the children in the amount of $100,000 annually. Accordingly, the Service computed the value of the life estate by taking the anticipated attrition of the corpus into account. Thus, when the valuation problem is establishing the fair market value of the discretionary interest, the anticipated pattern of distribution is probative. 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.

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. 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.

The trust also authorized the trustee to distribute principal for “health, support or maintenance.” 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.

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130 See id.
131 See id.
132 See id. at 358-59.
133 See id.
134 See id. at 358; FLA. STAT. ANN. § 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).
136 Id. at 1.
137 Id. at 2.
138 Id.
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.\footnote{See id.} The Service ruled favorably that the advancement of principal to the remainder beneficiaries did not cause a loss of GST exempt status.\footnote{See id. at 3.} 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.\footnote{See id.} 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.\footnote{See id. at 4.}

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.

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

IV. RESCISSION, REFORMATION, MODIFICATION, AND TERMINATION

A. What is Permitted?

1. Background\footnote{This portion of the article based in part on the analysis set forth in JESSE DUKEMINIER, ROBERT H. STIKOFF & JAMES LINDOREN, WILLS, TRUSTS AND ESTATES 641(8th ed. 2009).}

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.\footnote{Restatement (Third) of Property (Wills & Don. Trans.) § 10.1 (2003).} An ambiguity to which no rule of construction applies is resolved by

\footnote{\textsuperscript{139} See id.} \footnote{\textsuperscript{140} See id. at 3.} \footnote{\textsuperscript{141} See id.} \footnote{\textsuperscript{142} See id. at 4.} \footnote{\textsuperscript{143} This portion of the article based in part on the analysis set forth in JESSE DUKEMINIER, ROBERT H. STIKOFF & JAMES LINDOREN, WILLS, TRUSTS AND ESTATES 641(8th ed. 2009).} \footnote{\textsuperscript{144} 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.}
construing the document in accordance with the donor's intention to the extent that intention is established by a preponderance of the evidence. 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.146

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.147 By the 1950s, Parliament enacted the Variation of Trusts Act of 1958, which expressly permitted courts to modify or terminate trusts.148 Parliament enacted this legislation to allow beneficiaries to avoid adverse tax consequences resulting from the terms of existing irrevocable trusts.149 English law apparently treated the trust estate as belonging to the beneficiaries, particularly after the settlor's death.150 This view repudiated the settlor's continuing control over the disposition of the assets held in trust.151

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,152 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

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.

145 Id. at § 11.2.
146 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 reverse 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).

148 See Variation of Trusts Act, 1958, 6 & 7 Eliz. 2, c. 53, § 1 (Eng.).
149 See DUKEMINIER, ET AL., supra note 141.
150 See id.
151 See id.
152 20 N.E. 454 (Mass. 1889).
The Claflin court declined to terminate a trust prior to its stated age termination date. 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.

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 . . . .”

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, 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. The trustee also had discretion to pay principal for the daughter’s proper care, support, and maintenance. The trust contained a spendthrift clause prohibiting the beneficiary from selling, assigning, transferring, or encumbering her interest.

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.

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. 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 prevent a trust’s termination. 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.

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153 See id. at 456.
154 See id.
155 Id.
156 Id.
158 See id. at *1.
159 See id.
160 See id.
161 See id. at *2.
162 See id. at *4.
163 See id. at *5 (citing RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. e (2003)).
many years after the resolution of the beneficiary’s financial problems and still provided for a
trust. 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.

Accordingly, the court denied the petition for termination.

In Estate of Brown, 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. The trust’s primary purpose appeared to be
providing for the education of the life tenant. 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.”

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. A
support trust requires the trustee to use income and principal only to the extent necessary for
support. The trust was also not a spendthrift trust, even though the interests in the trust were
not transferable. 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. 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.” The court held that the italicized language indicated a second and material
purpose—providing a life-long income—that terminating the trust would defeat.

164 See id.
165 Id. at *6 (quoting Hopp v. Rain, 88 N.W. 2d 39, 45 (Iowa 1958) (internal quotation marks omitted)).
166 528 A. 2d 752 (Vt. 1987).
167 See id. at 753.
168 See id.
169 Id. at 754 (emphasis in original).
170 See id.
171 See id.
172 See id.
173 See id.
174 Id. (emphasis in original omitted).
175 See id.
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." 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. 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." 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.

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. 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. 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. Comment c states that consent by representatives may present issues when such consent diminishes the represented beneficiaries' interests, such as with a termination.

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. 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." 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.

The 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

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176 Restatement (Third) of Trusts § 64 (2003).
177 See id.
178 Id. § 65.
179 See id.
180 See id. cmt. b.
181 See id. § 65(1) & cmt. b.
182 See id. § 65 cmt. b.
183 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.").
184 See id. § 65 cmt. d.
185 Id.
186 See id.; discussion supra Part III.A.2.
the various interests created, and the circumstances surrounding the creation of the trust.”

Comment d also states that “[m]aterial purposes are not readily to be inferred.” Instead, a finding of a material purpose “requires some showing of a particular concern or objective on the part of the settlor, such as concern with regard to a beneficiary’s management skills, judgment, or level of maturity.” 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. In some states, a trust is automatically spendthrift unless the settlor provides otherwise. Comment e acknowledges that a spendthrift clause alone is insufficient to establish a material purpose to continue property in trust. 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.”

A modification that does not violate a material purpose of the trust may be easier to achieve than a termination. In a modification, the focus is on the particular amendment sought. 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.

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.

188 Id.
189 Id.
190 See id. cmt. e.
191 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”).
192 See RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. e (2003).
193 Id.
194 See id. cmt. f.
195 See id.
196 See id. cmt. h.
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.\(^{(197)}\) 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.\(^{(198)}\) Nevertheless, 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.\(^{(199)}\)

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.”\(^{(200)}\) 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.\(^{(201)}\) 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.\(^{(202)}\)

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.\(^{(203)}\)

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\(^{(198)}\) 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).

\(^{(199)}\) 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).


\(^{(201)}\) See id. § 66(2).

\(^{(202)}\) 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).

\(^{(203)}\) See, e.g., Treas. Reg. § 26. 2601-1(b)(4) (permitting modifications to the administrative provisions of a trust without adverse GST tax consequences).
B. Modern View of Changing Irrevocable Trusts Under the Uniform Trust Code

The Uniform Trust Code ("UTC") contains five separate provisions dealing with the reformation, modification, or termination of a trust, all of which appear in Article 4. 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. The Florida provisions are more liberal than the UTC's and therefore raise additional issues.

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. The statute permits modification upon satisfaction of one of the following three conditions:

- the purposes of the trust have been fulfilled or have become illegal, impossible, wasteful or impracticable to fulfill; . . .
- 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 . . .
- a material purpose of the trust no longer exists.

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." 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. 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." 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. The requirements of section

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205 See FLA. STAT. ANN. §§ 736.04113 to 0417 (West 2014).
206 See id.
207 See id. § 736.04113(1).
208 Id. § 736.04113(1)(a)–(c).
210 See FLA. STAT. ANN. § 736.04113.
211 Id. § 736.04113(3)(a).
212 See id. at § 736.04113(2)(a)–(d).
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.213 The trust instrument may not waive the provisions of section 736.04113.214

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.”215 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 deviation.216 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.217 In other words, Restatement (Third) of Trusts imposes on a trustee an affirmative duty to seek modification in appropriate circumstances.218 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 intent219 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.220 The FTC provision is broader, essentially combining the *Claflin* doctrine with the doctrine of equitable deviation.

In *Peck v. Peck*,221 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 wise dissipation of her assets. The remainder beneficiaries of the trust consented to its termination. The court reviewed *Preston v. City National Bank of Miami*,222 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(1072,281),(1100,319) 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.223

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213 See id. § 736.04113; discussion supra Part 111.A.2.
216 See id.
217 See id.
219 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).
221 133 So. 3d 587 (Fla. 2d DCA 2014).
222 294 So. 2d 11 (Fla. 3d DCA 1974).
223 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).
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*, 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. 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. No similar UTC provision exists. The section allows either a trustee or any qualified beneficiary to apply to the court for relief. 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 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.” 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.”

Section 736.04115 does not apply to a trust created prior to January 2001. 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. 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 might 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 judicial modification prohibition that avoids the application of FTC section 736.04115 appears absolute and does not expressly take into account that section 736.04113 is a mandatory provision permitting judicial modification such that a settlor cannot entirely preclude judicial modification of the trust. Although section 736.04115

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224 296 U.S. 93 (1935).
226 See FLA. STAT. ANN. § 736.04115 (West 2010).
227 See id. § 736.04115(1).
228 Id. § 736.04115(2)(a).
229 Id. § 736.04115(2)(b).
230 See id. § 736.04115(3).
231 See id.
232 See id. §§ 736.04113, 736.0105(2)(j).
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. The trustee's authority to make principal distributions in the first trust must be "absolute" as defined in the statute. The invasion in favor of another trust under section 736.04117 requires prior notice to qualified beneficiaries but does not require their consent. 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. Section 736.04117 does not abrogate the opportunity to decant under Phipps v. Palm Beach Trust Co., 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." 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.

Section 736.0410(2) permits any beneficiary to commence a judicial proceeding for review of a proposed nonjudicial modification. However, a nonjudicial modification apparently does not require notice to all beneficiaries, nor does section 736.0410(2) appear to provide relief if the modification already has taken effect. 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

233 See § 736.04117(1)(a)(1)-(3).
234 See id. § 736.04117(b).
235 See id. § 736.04117(b)(4).
236 See id.
237 196 So. 299 (Fla. 1940).
238 FLA. STAT. ANN. § 736.0412.
240 Cf. id. § 111, 7C U.L.A. 450 (allowing any "interested person" to ask for judicial approval).
241 See FLA. STAT. ANN. §§ 736.0412, 736.0410(2).
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. 242

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." 243 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. 244 A spendthrift clause does not preclude nonjudicial modification. 245

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 the only qualified beneficiary. 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." 246 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. 247 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.

244 See id. § 736.0412(4)(a)—(c).
245 See id. § 736.0412(2).
246 Treas. Reg. § 20. 2041-3(c)(2).
247 See id.
Section 736.0814 would not save the situation. Section 736.0814 addresses the powers of a trustee who is also a beneficiary. In that case, the section limits a power to make discretionary distributions to health, education, maintenance, and support as described in section 2041. 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. “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.” The court also may modify or terminate an uneconomic trust, even if the trust is larger than $50,000. Upon termination, the trustee must distribute the trust property in a manner consistent with the purposes of the trust. The comments to UTC section 414 suggest the trustee typically would make the distribution to the qualified beneficiaries in proportion to their actuarial interests. 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.” 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.

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). The trustee must apply or distribute trust property, in whole or in part, in a manner consistent with the settlor's charitable purposes.

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.\textsuperscript{259} The comment to UTC section 415 explains that scrivener's errors frequently cause mistakes of expression.\textsuperscript{260} 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.\textsuperscript{261} The comments also distinguish a reformation from what is, in effect, a construction to resolve an ambiguity.\textsuperscript{262} A reformation may add or delete language from the instrument, and reliance on extrinsic evidence will be essential.\textsuperscript{263} To protect the reliability of the extrinsic evidence, clear and convincing evidence must show that an error in expression or inducement occurred.\textsuperscript{264}

The leading case in Florida on the reformation of a trust is Robinson v. Robinson.\textsuperscript{265} 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.\textsuperscript{266} 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.\textsuperscript{267} 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.\textsuperscript{268} The will provided for a pour over to the trust.\textsuperscript{269} The Robinson court confirmed its earlier holding in In re Estate of Reese\textsuperscript{270} that a will cannot be reformed.\textsuperscript{271} 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."\textsuperscript{272} 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.\textsuperscript{273} 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.\textsuperscript{274} The court cited Forsythe v. Speilberger,\textsuperscript{275} in which the court refused to invalidate a trust based upon a unilateral
mistake in contents, not inducement.\textsuperscript{277} In addition, the surviving spouse sought to reform, not invalidate, the trust.\textsuperscript{278} 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.\textsuperscript{279} 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."\textsuperscript{280}

Reid v. Temple Judea\textsuperscript{281} 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.\textsuperscript{282} The court confirmed that a trustee has standing to bring a proceeding for reformation.\textsuperscript{283} In addition, the court stated the following:

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.\textsuperscript{284}

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\textsuperscript{285} and required that an unambiguous trust be interpreted according to the grantor's intent as expressed in the document (its plain meaning).\textsuperscript{286} 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.\textsuperscript{287} Section 736.0415 changed these rules to permit the introduction of extrinsic evidence even if the terms of the trust are unambiguous.\textsuperscript{288} Schroeder v. Gebhart\textsuperscript{289} 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.\textsuperscript{290}

\textsuperscript{277} See id.
\textsuperscript{278} See id.
\textsuperscript{279} See id.
\textsuperscript{280} Id. at 543.
\textsuperscript{281} 994 So. 2d 1146 (Fla. Dist. Ct. App. 2008).
\textsuperscript{282} See id. at 1150 n.6.
\textsuperscript{283} See id. at 1151.
\textsuperscript{284} 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).
\textsuperscript{288} See FLA. STAT. ANN. § 736.0415 (West 2010).
\textsuperscript{289} 825 So. 2d 442 (Fla. Dist. Ct. App. 2002).
\textsuperscript{290} See id at 446.
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. The court may provide that the modification has retroactive effect. 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. 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.

Section 736.0417 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." 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.

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. However, 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. 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." 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.

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.

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292 Id.
297 Id. § 736.0417(2).
299 See id.
300 Id.
301 See id.
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*, the Supreme Court held that a company realized a loss when it exchanged certain mortgage note interests for other notes that were "materially different." 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).

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. 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. If the tax event has already taken place, an attempt to undo the action giving rise to tax consequences may fail. As a general rule, a judicial reformation or other action will not change the tax consequences if the transaction in question is already complete. The so-called "completed transaction" doctrine states that one cannot unwind the tax consequences of a transaction that has already taken place.

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303 Id. at 566.
304 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).
306 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).
307 See id. at 445.
308 Id.
309 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.\textsuperscript{310}

The court in \textit{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.\textsuperscript{311} 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.\textsuperscript{312} On the other hand, cases such as \textit{Dodge v. United States},\textsuperscript{313} 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 \textit{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.\textsuperscript{314} In \textit{Dodge}, the Service was a party to the proceeding.\textsuperscript{315} Taxpayers have been more successful recently, particularly in Massachusetts.\textsuperscript{316}

\textsuperscript{310} See \textit{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); \textit{Estate of Hill v. Comm'r}, 64 T.C. 867, 879 (1975), aff'd without published opinion, 568 F. 2d 1365 (5th Cir.1978); \textit{Emerson Inst. v. United States}, 356 F. 2d 824, 826-27 (D.C. Cir. 1966) ("[T]he law appears well established that a nunc 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)); \textit{Piel v. Comm'r}, 340 F. 2d 887, 891 (2d Cir. 1965); \textit{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 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"); \textit{Eisenberg v. Comm'r}, 161 F. 2d 506, 511 (3d Cir. 1947); \textit{Sinopoulou v. Jones}, 154 F. 2d 648, 651 (10th Cir. 1946); \textit{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, \textit{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).

\textsuperscript{311} 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").

\textsuperscript{312} See id. at 1243.

\textsuperscript{313} See id. It would not appear that the taxpayer has the ability to make the Service a party to any proceeding. See Spivey, \textit{supra} note 299, at 346.

\textsuperscript{314} 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
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.” If, as the court found, state law permits such a rescission, 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*, the court held that a mistaken transfer was not a completed gift by virtue of the equitable right of reformation. 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. The taxpayer then sought judicial reformation of the trusts to make them revocable, which the court granted. The district court held that the gift into trust was incomplete for mistake and thus not subject to transfer tax. 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.

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. The taxpayer, a trust grantor, released all of her contingency reversionary interest in her GRIT and then attempted to rescind her action. 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.

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

318 See id. at *3.
320 See id. at 52.
321 See id. at 50.
322 See id.
323 See id. at 52.
326 See id. at 99-2326.
327 See id. at 99-2327 to -2328.
On a number of occasions, the Service has ruled in favor of permitting the reformation of an irrevocable trust to have retroactive effect. 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. 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. Accordingly, the Service recognized that the surviving spouse had a qualifying income interest for life for purposes of the federal estate tax marital deduction. The error arose out of the inclusion of language permitting discretionary payments of principal to the deceased spouse's descendants, 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.

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. 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.

Apparentlly, 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.

D. Bosch and the Importance of State Law

In *Commissioner v. Estate of Bosch*, 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. In a case consolidated into the Bosch decisions, the District Director of the Service was provided notice of application but did not appear. 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. The Supreme Court followed Erie v. Tompkins in holding that federal authorities must follow the state law as announced by the highest court of the state; however, "If 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.

In Estate of Kraus v. Commissioner, 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.

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 the decision to bind federal authorities for tax purposes (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. 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.

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, 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

337 See Van den Wymelenberg v. United States, 397 F. 2d 443, 445 (7th Cir. 1968).
338 See Bosch, 387 U.S. at 465.
339 See id.
340 U.S. 64 (1938).
341 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).
342 875 F. 2d 597 (7th Cir. 1989).
343 Id. at 601.
344 See Bosch, 387 U.S. at 464-65.
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, 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. Unfortunately for the taxpayer, the Kansas Supreme Court undid the relief she achieved in the lower court. The beneficiary sought modifications to an irrevocable trust created by her father. The court construed the proposed modifications under the Kansas version of the UTC. 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. 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. To the extent practicable, the court must make the modification in accordance with the settlor's probable intention. Contrary to the UTC, Kansas law presumes that a spendthrift clause constitutes a material purpose. 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. 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. 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. In addition, the proposed changes were in derogation of the interests of the other beneficiaries. Accordingly, the court denied the proposed relief.

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.

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348 234 P. 3d 793 (Kan. 2010).
349 See id. at 796.
350 See id. at 804.
351 See id. at 797-98.
352 See id. at 798-99.
353 See id.
354 See id. at 799.
355 See id.
356 See id. at 799-800.
357 See id. at 795.
358 See id at 801.
359 See id. at 801-04.
360 See id. at 801.
361 See id at 804.
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. In the ruling, the decedent made substantial gifts of property to a trust for his wife and children. 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. The trustee had an unrestricted power to withhold distributions and to apportion income and principal. 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. The court's decree was, however, contrary to the decision of the highest court of the state. The ruling concludes that Bosch does not void a lower court decree that is binding on the parties. Once the time for appeal elapses such that the decree binds the parties, the decree determines the parties' property rights. 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. The decree extinguishing the powers would therefore bind the Service, as the decedent clearly lacked the powers after the decree.

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, 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 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

364 See id.
365 Id.
366 See id.
367 See id.
368 See id.
369 See id. (citing Comm'r v. Estate of Bosch, 387 U.S. 456 (1967)).
370 See id.
371 See id.
372 See id.
decanting authority may create a negative inference that the settlor intentionally omitted the power.\(^{374}\)

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,\(^{375}\) 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.\(^{376}\)

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."\(^{377}\)

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.\(^{378}\) 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,\(^{379}\) 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


\(^{375}\) 142 Fla. 782, 196 So. 299 (1940).

\(^{376}\) Id. at 787, 301.

\(^{377}\) Id. at 786, 301.

\(^{378}\) 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.

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, 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. 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. 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

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380 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 §§ 2514(c) and 2041(b) of the Internal Revenue Code of 1986, as amended (the "Code"); unless otherwise specifically referenced, all section references in this document shall be references to the Code. The power to invade for one's own benefit (that is, to withdraw property from the trust) may cause the powerholder to be the owner of the trust for purposes of § 671 so that the income, deductions and credits against tax of the trust are attributed to the powerholder. See § 678(a). However, if the power is held in a fiduciary capacity, § 678 may not apply. See discussion in Blattmachr, Gans & Lo, "A Beneficiary as Trust Owner: Decoding Section 678," ACTEC JOURNAL, Fall 2009.

381 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).
trust in support of its conclusion that a trustee with discretionary distribution authority may do the same. 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.

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 powerholder’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 powerholder’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 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. 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. 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.

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

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383 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.)
384 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.
385 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.”
386 See Section 105 of the Uniform Trust Code, adopted by the National Conference of Commissioners on Uniform State Laws in 2003, 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.
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)(I)(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. 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)(I)(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 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, the Trustee exercised decanting authority under FTC section 736.04117 without providing notice to the qualified beneficiaries. The purpose of the

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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*, 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*, one of the parties to a proceeding for dissolution of marriage was the beneficiary of a third party trust. The trust appears to have been governed by Massachusetts law and provided that upon attaining age 35, the beneficiary would have periodically increasing rights to withdraw principal from the trust. The Trustees of the trust, during the pendency of the dissolution proceeding, decanted the trust to a new trust that

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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.  

391 317 Conn. 223 (2015).
eliminated the future withdrawal rights. The Trustees instituted a declaratory action seeking a ruling that they had validly exercised their authority to transfer the assets as to which withdrawal rights had not yet accrued 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.” The Ferri case supports the modern view that it is permissible for a trustee to decant away future rights to distributions, provided those rights have not yet vested but are subject to a contingency, such as one of survival to a stated age.

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.

In Devitt v. Wellin, 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, 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.

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393 152 So3d 719 (4th DCA 2014).
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. Potential Transfer Tax Consequences of a Trustee’s Action to Modify by Decanting or Otherwise

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. 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.

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. 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 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.

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. 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.

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.

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." 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. In particular, this would be true if the proceeding would be costly to the beneficiary who believes the likelihood of success to be minimal.

398 See id.
400 Id. cmt. c.
401 Id.
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. 403 In that case, the power might appear more akin to a power of appointment, which Restatement (Third) of Trusts acknowledges is not subject to fiduciary obligations and which, therefore, presumably cannot be opposed by a disgruntled beneficiary whose interests are diminished. 404

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. 405 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. 406 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. 407

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, 408 although the Service appears to analyze both cases in the same manner. 409 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. 410

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. 411 The rules do not apply to determine whether a modification results in a gift subject to gift tax,

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404 See Restatement (Third) of Trusts § 50 cmt. a (2003).
408 See id.
409 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).
410 See I.R.C. § 2603 (indicating that, in certain circumstances, the trustee may be personally liable for the GST 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. 412

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 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 period, measured from the date the original trust became irrevocable, will not [violate the foregoing rule]. 413

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

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. 414 One should note that the need for beneficiary consent or court intervention falls outside the exception. 415 A voluntary application to court, by itself, would seem to not have adverse tax consequences. 416 But if the

412 See id.
413 Id. § 26.2601-1(b)(4)(i)(A).
415 See id.
416 See id.
law requires court approval or beneficiary consent, then the power of distribution would fall outside the safe harbor of the regulation. 417

In Private Letter Ruling 200228007, the decedent created a separate testamentary trust for each of three children. 418 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. 419 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. 420 Finally, the 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. 421

Note that state property law determined that the grandchildren’s interests vested. 422 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. 423 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. 424 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. 425 Yet, because that result derived from state law governing the trust since its inception, 426 perhaps the Service considered the reduction involuntary and thus without

417 See id.
419 See id.
420 See id.
421 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).
423 See id.
426 See id.
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.427

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.428 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 Property429—does not create transfer tax risk because the beneficiaries have no means to object to its effective exercise.430

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.431

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.432 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.433 All the trust's income beneficiaries had died except one

427 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.
428 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).
429 RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 cmt. g (2011).
431 Id. § 26.2601-1(b)(4)(i)(B).
433 See id. at 5.
who was entitled to a share of the income for life.434  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.435  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.”436  The parties sought commutation of the
income beneficiary’s life interest.437  Subsequently, the state enacted a statute authorizing a
trustee to make adjustments between principal and income under a prudent investor standard.438
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.”439  The contingent
remaindermen opposed the requested relief.440

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.441  The court appointed
a special master who found that the modification would not materially impair accomplishment of
the trust’s purposes.442  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.443

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.444  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.”445  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.446  Accordingly, the Service ruled that the settlement created no gift tax
consequences.447

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434 See id.
435 See id. at 5-6.
436 Id. at 6.
437 See id.
438 See id.
439 Id.
440 See id.
441 See id. at 7.
442 See id. at 8.
443 See id. at 9.
444 See id. at 10.
445 Id.
446 Id.
447 See id. at 10-11.
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.\footnote{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.

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.\footnote{See Comm’r v. Estate of Bosch, 387 U.S. 456, 465 (1967).} 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.\footnote{See Harris v. Comm’r, 340 U.S. 106, 109 (1950).}

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.

V. CONCLUSION

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.