FLORIDA TRUST MODIFICATIONS AND DECANTING

By:

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I. BACKGROUND

A. The authority to modify a trust in Florida is generally found under Part IV of the Florida Trust Code ("FTC"). There is also common law in Florida which supplements the FTC and provides additional avenues for modification. Many practitioners, however, tend to overlook the common law avenues because these are not codified in the FTC. One should consider all of the options available for his or her specific circumstances when determining the best approach to accomplish the desired result.

B. The FTC was drafted after extensive consideration of the Uniform Trust Code ("UTC"). While some of the modification options available under the UTC were incorporated into the FTC, the FTC also contains additional options for modifications as well, including some that were included in Chapter 737 of the Florida Statutes prior to the enactment of the FTC. To the extent that certain provisions in the FTC were taken from the UTC, one should consider reviewing the Official Comments to the UTC for guidance where Florida case law is lacking.

C. Generally, the terms of a trust prevail over any provision of the FTC except for certain provisions enumerated under Florida Statutes § 736.0105.[1]

1. The modification statutes in the FTC that *cannot* be overridden by the terms of a trust, are:
    a. 736.0410 – Modification or termination of trust; proceedings for disapproval of judicial acts;
    b. 736.04113 – Judicial modification or irrevocable trust when modification is not inconsistent with settlor's purpose;
    c. 736.0413 – Cy pres;
    d. 736.0415 – Reformation to correct mistakes; and
    e. 736.0416 – Modification to achieve settlor's tax objectives.
2. The modification statutes that can be altered by the terms of a trust are:
    a. 736.04115 – Judicial modification of an irrevocable trust when modification is in best interests of beneficiaries;
    b. 736.04117 – Trustee's power to invade principal in trust;
    c. 736.0412 – Nonjudicial modification of irrevocable trust;
    d. 736.0414 – Modification or termination of uneconomic trust; and

[1] All references to "736" are to Chapter 736 of the Florida Statutes in effect as of the end of 2021, unless otherwise stated.

e. 736.0417 – Combination and division of trusts.

D. Reformation vs. Modification

1. Reformation

a. Reformation can be thought of as an equitable remedy to change the terms of a trust to comply with the original intent of the settlor.

b. Reformations are typically effective retroactively to the time at which the error occurred, although the IRS may not accept the retroactive effect for tax purposes.

c. Grounds for reformation include a mistake of law or fact, whether in expression or inducement, including a scrivener's error.

2. Modification

a. Generally, a prospective change to the trust terms for one or more reasons sanctioned under law even though the original provisions of the trust are not inconsistent with the settlor's intent and there was no mistake.

II. <u>CONSIDERATIONS IN TRUST MODIFICATIONS</u>

A. What is the purpose of the modification? What provisions are being changed?

1. Are the desired modifications administrative or are substantive rights or interests of the beneficiaries being altered?

B. Do all parties have a seat at the table?

1. For those beneficiaries or interested persons who are not parties to the modification, consider whether their interests may or should be virtually represented, and thus bound by the modification.

a. 736.0301(2) – "Actions taken by a person who represents the interests of another person under [Part III of the FTC] are binding on the person whose interests are represented to the same extent as if the actions had been taken by the person whose interests are represented."

b. 736.0302 – Representation by holder of power of appointment

i. The holder of a power of appointment may represent and bind persons whose interests, as permissible appointees, takers in default, or otherwise, are subject to the power. However, such representation cannot occur (1) with respect to any matter determined by a court to involve fraud or bad faith by the trustee, or (2) if the holder of the power of appointment is also the trustee.

ii. Takers in default may represent and bind persons whose interests, as permissible appointees, are subject to the power.

iii. Note that this statute does not (1) distinguish between a special and general power of appointment or (2) prohibit a power holder from representing another person when there is a conflict of interest between the power holder and the represented party. These are changes from the UTC. Further, eliminating the prohibition on representation when a conflict exists is different than 736.0303 and 736.0304, which prohibit representation by fiduciaries, parents, and persons having substantially identical interests when a conflict of interest exists. Perhaps one rationale for permitting representation by a powerholder in light of a conflict is that power holders often have the ability to appoint assets away from the party or parties the power holder is representing. Finally, even though a power holder may not be prohibited from representing a party with whom he or she has a conflict of interest does not mean the power holder is absolved of liability for doing so.

c. 736.0303 – Representation by fiduciaries and parents
    i. To the extent there is no conflict of interest between the representative and the represented party with respect to a particular question or dispute:
        (a) A guardian of the property may bind the estate of the guardian that such guardian controls;
        (b) An agent with authority to act on the issue may bind the principal;
        (c) A trustee may bind the trust beneficiaries;
        (d) A personal representative may bind persons interested in the estate; and
        (e) A parent may bind the parent's unborn child, or the parent's minor child *if* a guardian of the property for the minor child has not been appointed.

d. 736.0304 – Representation by person having substantially identical interest
    i. Unless otherwise represented, a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable, may be represented and bound by another person having a substantially identical interest with respect to the particular question or dispute, but only to the extent there is no conflict of interest between the representative and the person represented.

e. 736.0305 – Appointment of representative
    i. A court may appoint a representative if it determines that an interest is not represented or that the representation is inadequate.
    ii. The representative can be appointed for any matter arising under the FTC, such as receiving notice or entering into a nonjudicial settlement agreement, regardless of whether a judicial proceeding is pending.
    iii. A common situation where this may occur is when a minor child who is a beneficiary does not have any adult siblings who are also beneficiaries and the trust action at issue benefits the child's parent, thereby creating a conflict of interest prohibiting the parent from representing the interests of the child.

f. 736.0306 – Designated representative
    i. The trust instrument may designate a representative to represent and bind a beneficiary, or authorize another person (other than the trustee) to designate a representative for a beneficiary.
    ii. Trustees cannot represent beneficiaries as a designated representative.
    iii. A beneficiary may represent another beneficiary only if the representing beneficiary was named by the settlor or is the represented beneficiary's spouse or a grandparent or descendant of a grandparent of the represented beneficiary or represented beneficiary's spouse.
    iv. There is a lack of case law in Florida defining the potential liability of a designated representative. Accordingly, although 736.0306(4) provides that no person designated is liable to the represented beneficiary or anyone claiming through such beneficiary, for actions or omissions to act made in good faith, many practitioners still have concerns as to the extent of liability a designated representative may have, especially if the designated representative decides not to notify the represented beneficiary prior to binding him or her. Further, there is concern that failing to provide any notice to the represented

beficiary may violate the beneficiary's constitutional due process rights. For these reasons, conservative trustees, including corporate trustees, may be hesitant to rely on actions of a designated representative with respect to a trust modification.

g. 736.0110 – Others treated as qualified beneficiaries
   i. Subsection (3) states that the Attorney General may assert the rights of a qualified beneficiary with respect to a charitable trust having its principal place of administration in Florida.

C. Do the terms of the trust authorize or restrict modification, either nonjudicially or judicially?
   1. Certain avenues of modification may be prohibited by the terms of a trust, while others cannot be. See Section I.C. above. Further, the trust may provide a mechanism to modify the trust beyond what is expressly available under the FTC.
   2. One must always look to the settlor's intent and the trust terms. As stated in several cases, the polestar of trust interpretation is the settlor's intent, and in determining the settlor's intent, the court should not resort to isolated words and phrases, but instead should construe the instrument as a whole taking into account the general dispositional scheme. *Robert v. Sarros*, 920 So. 2d 193 (Fla. 2d DCA 2006); *Pounds v. Pounds*, 703 So. 2d 487 (Fla. 5th DCA 1997).
   3. Some modifications under the FTC may only be accomplished if they would not be inconsistent with the settlors' intent (see e.g., 736.04113, 736.0416). Other modifications avenues are not limited by the settlors' intent. See e.g., 736.0412 and 736.04115.

D. After consideration of the trust terms, what avenues for modification are available under the FTC or common law?

E. What are the sources of liability for the trustee?
   1. Just because the trustee may have authority to modify a trust does not mean the trustee *should* exercise that authority.
   2. Trustees have a duty to act in the best interests of the beneficiaries, taking into account the terms and purposes of the trust and the intent of the settlor, not just the interests of the beneficiary who may be seeking to have the trust modified for his or her own personal gain.
   3. Qualified beneficiaries generally have the same ability to file a judicial modification action that a trustee possesses under the FTC. Therefore, consider whether the trustee should even be the party bringing the modification action.
   4. Some modifications only require the involvement of qualified beneficiaries as opposed to non-qualified beneficiaries and interested persons. Beneficiaries who are not "qualified beneficiaries" include those beneficiaries with future interests, whether vested or contingent, holders of a power of appointment, and those in favor of whom a power of appointment has been irrevocably exercised. 736.0103(4). Including only qualified beneficiaries will not foreclose potential claims from interested persons and beneficiaries who are not "qualified beneficiaries". Further, it is not always clear who should be included as a qualified beneficiary. Thus, a trustee should be cognizant of joining any interested persons and beneficiaries who may not be qualified beneficiaries but could potentially have claims against the trustee arising from the modification.

F. What are the tax consequences of the modification?
   1. See Section VI below for discussion.
G. The path of least resistance (i.e., nonjudicial modification) is not always the most appropriate path.
   1. Nowadays, many trust modifications can be accomplished without court involvement by agreement among the trustee and beneficiaries. Depending upon the nature of the modification and the potential financial risks, however, it may be more appropriate to pursue judicial recourse.
   2. The tax consequences of a modification may be influenced by whether a bona fide dispute existed between the trustee(s) and/or beneficiaries. One factor that the IRS often considers to evaluate whether a bona fide dispute truly exists is whether the parties had separate legal representation. Thus, in significant matters in which one or more parties may be relying on the presence of a bona fide dispute for tax reasons, it may be more prudent to pursue judicial recourse with separate representation. As discussed in Section VI below, however, the IRS generally is not bound by state court decisions unless it is the decision of the highest state court that can rule on the issue.
   3. Corporate trustees are becoming more amenable to nonjudicial modifications, but if the result would implicate any potential liability risks on their part, judicial modification still seems to be the preferred route.

III. <u>JUDICIAL MODIFICATION AND REFORMATION</u>

A. Modification Not Inconsistent with Settlor's Purpose - 736.04113
   1. A court may modify the terms of an irrevocable trust if:
      a. The purposes of the trust have been fulfilled or have become illegal, impossible, wasteful or impracticable to fulfill;
      b. Because of circumstances not anticipated by the settlor, compliance with the trust's terms would defeat or substantially impair the accomplishment of a material purpose of the trust; or
      c. A material purpose of the trust no longer exists.
   2. A court may:
      a. Amend or change the terms of the trust, specifically including those governing distribution of income or principal or terms governing administration;
      b. Terminate the trust in whole or in part;
      c. Direct or permit the trustee to do things that are not authorized or that are expressly prohibited by the terms of the trust; and/or
      d. Prohibit the trustee from doing things that the trust permits or directs them to do.
   3. Trustee or qualified beneficiary may apply to the court.
   4. Court considerations:
      a. Trust terms and purposes;
      b. Facts and circumstances regarding creation;
      c. Extrinsic evidence relevant to the proposed modification;
      d. Spendthrift provisions – these provisions are to be considered, but their presence will not preclude trust modification.
   5. What may a party argue is an unanticipated change in circumstances that warrants modification? Section 736.04113 does not provide guidance; however, the following are common arguments made by parties:

a. Beneficiary develops health issues;
b. Trust assets grow significantly in value, but the trust terms are not flexible enough to increase distributions;
c. Trust assets decline in value and the continued administration according to the same terms is not prudent;
d. Change in the tax laws;
e. Change in the creditor protection laws;
f. Beneficiary's marriage or divorce;
g. Change in beneficiary's financial condition;
h. Litigation depleting trust resources; and
i. Adoption of an adult by a beneficiary. See *Dennis v. Kline*, 120 So. 3d 11 (Fla. 4th DCA 2013).

* Note that an unanticipated change of circumstances is not sufficient, by itself, to justify the modification. One must show that compliance with the existing terms would defeat or substantially impair the accomplishment of a material purpose of the trust *as a result of the change in circumstances*.

6. What is a material purpose?
   a. Neither 736.04113 nor Florida case law define "material purpose." Restatements (Third) of Trusts Section 65, comment d states the following:
      i. The identification and weighting of purposes under this Section frequently involve a relatively subjective process of interpretation and application of judgment to a particular situation, much as purposes or underlying objectives of settlors in other respects are often left to be inferred from specific terms of a trust, the nature of the various interests created, and the circumstances surrounding the creation of the trust
      ii. Material purposes are not readily to be inferred. A finding of such a purpose generally requires some showing of a particular concern or objective on the part of the settlor, such as concern with regard to the beneficiary's management skills, judgment, or level of maturity. Thus, a court may look for some circumstantial or other evidence indicating that the trust arrangement represented to the settlor more than a method of allocating the benefits of property among multiple beneficiaries, or a means of offering to the beneficiaries (but not imposing on them) a particular advantage. Sometimes, of course, the very nature or design of a trust suggests its protective nature or some other marital purpose.
   b. 736.0404 provides general guidance, stating that the purposes of a trust must be lawful, not contrary to public policy, and possible to achieve.
   c. Examples of material purposes may include:
      i. Protection of family wealth from creditors or divorce;
      ii. Providing a resource for the health, education, maintenance and/or support of a beneficiary;
      iii. Providing a mechanism for the management and administration of multi-generational wealth;
      iv. Minimizing transfer tax consequences on the transfer of wealth among multiple generations;

v. Managing wealth for the benefit of a beneficiary who has not yet attained the age of majority or maturity; and
vi. Encouraging a beneficiary to become a productive member of society (e.g., incentive trusts).

7. A trust cannot be drafted to prohibit judicial modification under this section. See 736.0105(2)(j).

B. Modification in Best Interests of Beneficiaries - 736.04115

1. A court may modify an irrevocable trust if compliance with the existing terms of the trust is not in the best interests of the beneficiaries.
2. Trustee or qualified beneficiary may apply to the court.
3. This section is *not* available for:
   a. Irrevocable trusts created prior to January 1, 2001.
   b. Irrevocable trusts created after December 31, 2000 that either have the "old" RAP period (lives in being plus 21 years or 90 years), or expressly prohibit judicial modification.
   c. Note: Revocable trusts are considered to be created as an irrevocable trust when the right of revocation terminates.
4. Court considerations:
   a. Intent of the settlor, taking into account current circumstances and the best interests of the beneficiaries;
   b. Terms and purposes of the trust;
   c. Facts and circumstances surrounding creation;
   d. Extrinsic evidence relevant to the proposed modification; and
   e. Spendthrift provisions are to be considered, but their presence will not preclude the trust modification.
5. Additional points
   a. For modifications pursuant to 736.04115, it is <u>not</u> necessary to show that the purposes have been fulfilled, or become illegal, impossible, wasteful or impractical to fulfill, or that there has been a change of circumstances, or that a material purpose no longer exists.
   b. "Best interests" is a very broad term, leaving the door open for parties to modify almost any trust under this provision, provided that the trust itself meets the creation date and RAP requirements.
   c. Modifications pursuant to 736.04115 can be prevented by including a prohibition against judicial modification in the trust terms.

C. Cy Pres - 736.0413

1. A court may modify or terminate a trust if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful.
2. The settlor, trustee or any qualified beneficiary can apply to the court.
3. If cy pres is applied, the court may direct trust property to be applied or distributed, in whole or in part, in a manner consistent with the settlor's charitable purposes.
4. Often applied where the original charity named in the trust either ceases to exist or loses its tax-exempt status as a charity and the settlor's intent for the funds to serve a charitable purpose is evident.
5. *Christian Herald Ass'n v. First Nat. Bank of Tampa*, 40 So. 2d 563 (Fla. 1949) - Testator made a devise of property to Christian Herald Association of New Jersey but

that organization was dissolved prior to the drafting of the will. The court applied the cy pres doctrine to carry out the intent of the testator by vesting title to such property in the Christian Herald Association of New York, a corporation that was the successor to the dissolved corporation and whose purpose and function were similar to that of the dissolved corporation.

6. See also *In re Williams' Estate*, 59 So. 2d 13 (Fla. 1952); *Sheldon v. Powell*, 128 So. 258 (Fla. 1930); *Jewish Guild for the Blind v. First Nat. Bank in St. Petersburg*, 226 So. 2d 414 (Fla. 2d DCA 1969).

D. Modification or Termination of Uneconomic Trusts - 736.0414(2)
   1. A court may modify or terminate a trust OR remove a trustee and appoint a new trustee if the court determines that the value of the trust property is insufficient to justify the cost of administration.
   2. Trustee or qualified beneficiary may apply to the court.
   3. If a trust is terminated under this section, the trustee shall distribute the trust property "in a manner consistent with the purposes of the trust." Typically, this means distributing out the assets amongst the qualified beneficiaries in accordance with the actuarial value of their interests or in some other manner agreed to amongst the trustee and qualified beneficiaries.
   4. Does not apply to an easement for conservation or preservation. The rationale stated under the Comments to the UTC is that such easements are different than cash and securities, and the creators of such easements likely would prefer the easement to continue even if it has a low value.
   5. Additional points
      a. Judicial termination may be used regardless of the value of the trust as long as a court determines the value is insufficient to justify the courts.
      b. This section may come into play where a trust requires a corporate trustee to serve, and the assets of the trust are small enough that the corporate trustee is charging a minimum fee (e.g., $10,000) that is disproportionately large compared to the trust assets.
      c. Terminating the trust does not necessarily mean all assets are being paid to the current beneficiaries. Instead, the assets may be paid out among the current and remainder beneficiaries based on the actuarial value of their interests or some other agreement.
      d. The settlor can draft to prohibit or modify the requirements of this section. Section 736.0414 is not a mandatory provision of the FTC. See 736.0105.

E. Reformation to Correct Mistakes - 736.0415
   1. A court may reform the terms of a trust, *even if unambiguous*, to conform the terms to the settlor's intent if it can be proven by clear and convincing evidence that <u>BOTH</u> of the following have been affected by a mistake of fact or law, whether in expression or inducement:
      a. Settlor's intent; and
      b. Terms of the trust.
   2. Settlor or interested person may apply to the court.
   3. Evidence of the settlor's intent can be considered even when the evidence contradicts an apparent plan meaning of the trust instrument.

4. Mistake of expression occurs when the terms of the trust misstate the settlor's intention, fail to include a term that was intended to be included, or include a term that was not intended to be included. See Comment to UTC § 415.
5. Mistake of inducement occurs when the terms accurately reflect what the settlor intended to be included or excluded but the settlor's intent was based on a mistake of fact or law. See Comment to UTC § 415.
6. The heightened standard of proof of clear and convincing evidence is used to guard against the possibility of unreliable or contrived evidence. See Comment to UTC § 415.
7. Reformation of trusts in Florida is allowable both under the common law and under the FTC. See *Robinson v. Robinson*, 720 So. 2d 540 (Fla. 4th DCA 1998).
8. Examples:
   a. In *Megiel-Rollo v. Megiel*, 162 So. 3d 1088 (Fla. 2d DCA 2015) the court held that and the power of the courts to reform a trust is not confined to the correction of "simple scrivener's errors" and went so far as to allow, on remand, the reformation of a trust which failed to include a schedule of remainder beneficiaries to receive trust assets upon the decedent's death.
   b. See also *Morey v. Everbank*, 93 So. 3d 482, 484 (Fla. 2d DCA 2012); *Reid v. Est. of Sonder*, 63 So. 3d 7, 9 (Fla. 3d DCA 2011).
   c. Extrinsic evidence, including the testimony and files of the drafting attorney, can be used to show that there was a mistake in transcription. See Restatement (Third) of Property (Wills and Donative Transfers) § 12.1 i, Illustrations 4 and 5 (2003).
      i. Illustration 4. G's will devised "$1,000 to A." Extrinsic evidence, including the testimony and files of the drafting attorney, shows that there was a mistake in transcription and that G's intention was to devise $10,000 to A.
         If this evidence satisfies the clear-and-convincing-evidence standard of proof, the will is reformed to substitute "$10,000" for "$1,000."
      ii. Illustration 5. G created an inter vivos trust. The trust document did not contain a clause reserving to G a power to revoke the trust. Controlling law provides that a trust is irrevocable in the absence of an expressly retained power to revoke. After G signed the document, G's financial condition changed and G sought to revoke the trust. Extrinsic evidence shows that G intended to create a revocable trust and so instructed her attorney; and shows that G's attorney mistakenly failed to include the revocation clause.
         If this evidence satisfies the clear-and-convincing-evidence standard of proof, the trust document is reformed to insert the mistakenly omitted power to revoke.
      iii. See also Restatement (Third) of Trusts § 62 (2003) Illustration 1 where S established a testamentary trust for the benefit of his brother and sister and their families. The language of S's will expressly states that the trust is to terminate and be distributed on the death of S's sister. Clear and convincing evidence establishes that S had intended to provide for the trust to terminate on the death of the survivor of his brother and sister and that the erroneous time of termination stated in the will was the result of a "scrivener's error" by

S's lawyer. The termination provision of the trust will be reformed to reflect S's intention.

F. Modification to Achieve Settlor's Tax Objectives - 736.0416
   1. A court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intent in order to achieve the settlor's tax objectives.
   2. Any interested person may apply to the court.
   3. Modification may have retroactive effect.
   4. Be aware that, although the state court may approve a modification on the basis that it will achieve the settlor's tax objectives, the IRS generally is not bound by the state court decision. See Section VI below for discussion of the *Estate of Bosch* case. Therefore, the IRS could impose a different tax result than intended; however, the modification would still be binding for state law purposes.
   5. Examples of modifications for tax reasons that are recognized in the Internal Revenue Code[2]:
      a. Code § 2055(e) – qualified reformation of a split interest trust to qualify for the estate tax charitable deduction.
      b. Treas. Reg. § 20.2056A-4(a) – reformation to qualify a trust for the benefit of a noncitizen surviving spouse as a qualified domestic trust (QDOT) for estate tax purposes.
   6. Note that the significant changes in the transfer tax laws in recent years, including the recent enactment of what is commonly referred to as the Tax Cuts and Jobs Act of 2017, arguably provide adequate grounds to justify a modification pursuant to 736.0416. For example, a trust could be modified to utilize a beneficiary's increased estate or GST tax exemption and take advantage of a step-up in basis on appreciated assets under Code § 1014.

G. Attorney's fees and costs – 736.1004
   1. In proceedings arising under 736.0410 – 736.0417, the court "shall award taxable costs as in chancery actions, including attorney fees and guardian ad litem fees."
   2. When awarding taxable costs, including attorney fees, the court in its discretion may direct payment from a party's interest, if any, in the trust or enter a judgment that may be satisfied from other property of the party, or both.
   3. The phrase "as in chancery actions" generally means that costs follow the judgment unless there are circumstances that render application of this rule unjust. *In re Estate of Simon v. Levin & Fishman, P.A.*, 549 So. 2d 210 (Fla. 3d DCA 1989).

H. Reformation of Wills -
   1. Prior to 2011, Florida courts consistently held that a will could not be reformed or rewritten. *Owen v. Estate of Davis ex rel. Holzauser*, 930 So. 2d 873 (Fla. 2d DCA 2000); *In re Estate of Guess*, 213 So. 2d 638 (Fla. 3d DCA 1968); and *In re Estate of Reese*, 622 So. 2d 157 (Fla. 4th DCA 1993). Some courts, however, effectively permitted the reformation of a will under the guise of a construction action. See *In re Estate of Reese*, 622 So. 2d 157 (Fla. 4th DCA 1993) and *Wilson v. First Florida Bank*, 498 So. 2d 1289 (Fla. 2d DCA 1986).
   2. Recognizing that many other states had adopted the modern approach of permitting will reformations as promulgated by the Restatement Third Property (Wills and Other

[2] All references to the Internal Revenue Code or "Code" shall be to the Internal Revenue Code of 1986, as amended.

Donative Transfers) and the Uniform Probate Code, and that virtually all other testamentary instruments could be reformed under law, the Florida Legislature enacted sections 732.615, 732.616 and 733.1061 of the Florida Statutes in 2011 to provide statutory mechanisms for reforming a will to correct mistakes, modifying a will to achieve testator's tax objectives, and allocating fees and costs for will reformation proceedings.

3. Reformation to Correct Mistakes – F.S. § 732.615
    a. The court may reform the terms of a will, even if unambiguous, to conform the terms to the testator's intent if it is proved by clear and convincing evidence that both the accomplishment of the testator's intent and the terms of the will were affected by a mistake of fact or law, whether in expression or inducement.
    b. In determining the testator's original intent, the court may consider evidence relevant to the testator's intent even though the evidence contradicts an apparent plain meaning of the will.
    c. Any interested person may apply to the court.
    d. Clear and convincing evidence standard requires that the evidence must be found to be credible, the facts to which the witnesses testify must be distinctly remembered; the testimony must be precise and explicit and the witnesses must be lacking in confusion as to the facts in issue. See *Slomowitz v. Walker*, 429 So. 2d 797 (Fla. 2d DCA 1983).
    e. A mistake in expression is one in which the will includes a provision that misstates the testator's intent, includes a provision that was not intended to be included or fails to include a provision that was intended to be included. This would encompass most scriveners' errors.
    f. A mistake in the inducement arises when a donative document includes a term that was intended to be included or fails to include a term that was not intended to be included, but the intention to include or not to include the term was the product of a mistake of fact or law. An example of a mistake in the inducement for a will might be if the testator omitted a child he mistakenly believed to be deceased at the time the will was executed.
    g. In order to determine the testator's original intent, the court may consider extrinsic evidence even if the evidence contradicts the plain meaning of the will. Prior to 2011, if the will was clear and unambiguous on its face, extrinsic evidence could not be admitted and the court could not rewrite the will or add language to bring the document in line with the actual intent of the testator.
    h. Reformation of a will relates back and alters the document nunc pro tunc, not as of the day the reformation order was entered.
    i. The statute is comparable to an existing provision applicable to testamentary trusts, revocable trusts and other trusts under 736.0415.
4. Modification to achieve testator's tax objectives – F.S. § 732.616
    a. To achieve the testator's tax objectives, the court may modify the terms of a will in a manner that is not contrary to the testator's probable intent. The court may provide that the modification has retroactive effect.
    b. In order to determine the testator's tax objectives, the court will likely consider extrinsic evidence even if the evidence contradicts the plain meaning of the will.
    c. Any interested person may apply to the court.

d. It is not necessary to show an ambiguity exists to modify a will under 732.616.
e. Note that the statute does not reference a clear and convincing standard. For purposes of 732.616, the standard is less rigorous because the concerns implicated in a reformation to correct mistakes are not present.
f. As with 736.0416, although the state court may approve a modification on the basis that it will achieve the settlor's tax objectives, the IRS generally is not bound by the state court decision. See Section VI below for discussion of the *Estate of Bosch* case. Therefore, the IRS could impose a different tax result than intended; however, the modification would still be binding for state law purposes.

5. Fees and costs; will reformation and modification – F.S. § 733.1061
   a. In a proceeding arising under s. 732.615 or s. 732.616, the court shall award taxable costs as in chancery actions, including attorney's fees and guardian ad litem fees.
   b. When awarding taxable costs, including attorney's fees and guardian ad litem fees, the court in its discretion may direct payment from a party's interest, if any, in the estate or enter a judgment which may be satisfied from other property of the party, or both.
   c. As in 736.1004, the phrase "as in chancery actions" generally means that costs follow the judgment unless there are circumstances that render application of this rule unjust. *In re Estate of Simon v. Levin & Fishman, P.A.*, 549 So. 2d 210 (Fla. 3d DCA 1989).

IV. <u>NONJUDICIAL MODIFICATION</u>

A. Nonjudicial Modification - 736.0412

1. Trust may be modified at any time after the settlor's death upon the unanimous agreement of the trustee and all qualified beneficiaries.
2. No justification is necessary for modification or termination as long as the trustee and all qualified beneficiaries agree.
3. This section is <u>not</u> available for:
   a. Irrevocable trusts created prior to January 1, 2001.
   b. Irrevocable trusts created after December 31, 2000 that have the "old" RAP period (lives in being plus 21 years or 90 years) *unless* the terms of the trust expressly authorize nonjudicial modification.
   c. Irrevocable trusts for which a charitable deduction is allowed until the termination of all charitable interests. This restriction is intended to preserve the deductibility of charitable trusts for federal tax purposes.
   d. Note: Revocable trust are considered to be created as an irrevocable trust when the right of revocation terminates.
4. A nonjudicial modification under this section may:
   a. Amend or change the terms of the trust, specifically including those governing distribution of income or principal or terms governing administration;
   b. Terminate the trust in whole or in part;
   c. Direct or permit the trustee to do things that are not authorized or that are expressly prohibited by the terms of the trust; and/or
   d. Prohibit the trustee from doing things that the trust permits or directs them to do.

    e. Note: These are the same modifications that a court may make under § 736.04113(2).
5. Additional notes:
    a. Representation under 736.0301-736.0306 is expressly permitted to bind beneficiaries who are not part of the nonjudicial modification agreement. Although such representation is permitted, the representative could still have liability to the represented party for doing so.
    b. Modification is only permitted after the settlor's death. This limitation was included because there was some concern that a settlor could be deemed to possess a Code § 2036 or 2038 power (causing the inclusion of trust assets in the settlor's gross estate for estate tax purposes) if the settlor could participate in the modification, either directly or indirectly. See Florida House of Representatives Staff Analysis for HB 425, p. 21 (2006), available at http://archive.flsenate.gov/data/session /2006/House/bills/analysis/pdf/h0425d.EDTB.pdf. But see, e.g., PLRs 201417001, 201417002, 201233008.
    c. For short-term trusts (i.e., those with a RAP of lives in being plus 21 years or 90 years), the trust terms must expressly authorize nonjudicial modification for 736.0412 to be available.
    d. For long-term trusts (i.e., those with a RAP period *longer than* lives in being plus 21 years or 90 years), the availability of 736.0412 is mandatory and cannot be overridden by the terms of the trust. See 736.0105(2)(k). The policy argument is that long-term trusts need greater flexibility than short-term trusts. However, the anomaly that has been created is that short-term trusts can end up being locked up longer than long-term trusts because 736.0412 cannot be used for short-term trusts, but long-term trusts can be modified the day after the settlor's death. There has been some discussion in RPPTL of proposing legislation either (1) permitting settlors to draft against 736.0412 for long-term trusts or (2) prohibiting nonjudicial modification under 736.0412 for the first 90 years of a long-term trust in order to provide consistent treatment for short-term and long-term trusts.
    e. The existence of a spendthrift provision, or even a provision prohibiting amendment or revocation of the trust, will not prevent modification under this section.

B. Termination of Uneconomic Trusts – 736.0414(1)
1. After notice to qualified beneficiaries, a trustee may terminate a trust if the value of the trust property is less than $50,000 and the trustee concludes that the value of the trust property is insufficient to justify the cost of administration.
2. If a trust is terminated under this section, the trustee must distribute the trust property in a manner consistent with the purposes of the trust.
3. This is the nonjudicial counterpart of the judicial modification/termination for uneconomic trusts discussed above.
4. Termination under this section can be prohibited by including a provision in the trust. Further, the settlor may specify a higher or lower threshold for termination.
5. If a qualified beneficiary objects upon receipt of the notice, then the qualified beneficiary may commence a judicial proceeding to block the trustee's termination.

C. Nonjudicial Settlement Agreements – 736.0111
    1. "Interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust."
    2. The term "interested persons" is defined for purposes of this section to mean persons whose interest would be affected by a settlement agreement.
    3. An interested person may request a court to approve or disapprove a nonjudical settlement agreement, but judicial approval is not required.
    4. Issues that may be resolved by a nonjudicial settlement agreement include, but are not limited to:
        a. Interpretation or construction of trust terms;
        b. Approval of a trustee's report or accounting;
        c. Direction to a trustee to refrain from performing a specific act or the grant to a trustee of a necessary or desirable power;
        d. Resignation or appointment of a trustee and the determination of trustee compensation;
        e. Transfer of principal place of administration; and
        f. Liability of a trustee for an action relating to the trust.
    5. The only limitation imposed on a nonjudicial settlement agreement is that it is valid only to the extent the terms and conditions could be properly approved by a court. Thus, a nonjudicial settlement agreement can be used to modify or terminate a trust as long as a court could approve such modification or termination pursuant to one of the aforementioned judicial modification options under the FTC.
    6. Nonjudicial settlement agreements are intended to encourage the nonjudicial resolution of trust matters. As a result, having 736.0111 effectively expands all judicial modification avenues discussed in Section III above into nonjudicial modification options as well.

D. Trustee's Power to Invade Principal in Trust ("Decanting") – 736.04117
    1. See Section V below.

E. Modification by Unanimous Consent of the Settlor and Beneficiaries – Common Law
    1. A trust can be modified or terminated by unanimous agreement of the settlor and beneficiaries, even if a trustee objects.
    2. *Peck v. Peck,* 133 So. 3d 587 (Fla. 2d DCA 2014)
        a. Bernard Peck prepared a trust for his daughter, Constance, and funded it with gifts from a UTMA that was previously set up for her. Constance was named the settlor and co-trustee. The trust provided for all income to be paid to Constance during her life and also gave her a testamentary power of appointment over the remainder. Additional funds were transferred to the trust upon Bernard's death in 2009. In 2012, Constance filed a petition to terminate her trust. Her children, who were the remainder beneficiaries, agreed to the termination, but her brother, Daniel, who was a co-trustee, objected. The court held that Constance, as settlor of her trust, and her children, as the beneficiaries, had the right under common law to terminate Constance's trust notwithstanding the objection from her co-trustee and notwithstanding that such termination may defeat Bernard's intent with respect to the amounts he added to the trust at his death.
    3. See also *Smith v. Massachusetts Mutual Life Insurance Company*, 156 So. 498 (1934) and *Preston v. City National Bank of Miami*, 294 So. 2d 11 (Fla. 3d DCA 1974).

F. Trust Protectors / Trust Directors
   1. It is not uncommon for trusts to include the appointment of a trust protector or director who is not a trustee, but has the authority to modify the terms of a trust under certain circumstances, such as to achieve tax objectives, change administrative provisions or add or remove beneficiaries.
   2. 736.0808 (pre-July 1, 2021 law)
      a. Originally enacted in 2006, 736.0808 expressly (a) permitted the appointment of a person other than the trustee to direct the modification or termination of a trust and (b) provided that such a person was presumptively a fiduciary required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries.
      b. Section 736.0808 was copied from UTC § 808. The comment to UTC § 808 states that "subsections (b)-(d) ratify the use of trust protectors and advisers . . . 'Advisers' have long been used for certain trustee functions, such as the power to direct investments or manage a closely-held business. 'Trust protector' . . . is more recent and usually connotes the grant of greater powers, sometimes including the power to amend or terminate the trust."
      c. Notably, 736.0105 did not include 736.0808 as a provision that could not be modified by the terms of the trust. Therefore, it appeared that a settlor was free to draft the trust protector powers and obligations as the settlor desired. The Comment to UTC § 808 acknowledged this flexibility, stating "[t]he provisions of this section may be altered in the terms of the trust. . . A settlor can provide that the trustee must accept the decision of the power holder without question. Or a settlor could provide that the holder of the power is not to be held to the standards of a fiduciary."
      d. Many practitioners, however, felt that 736.0808 did not sufficiently address legal concerns that had developed over time relating to the use of trust protectors and directors, such as the applicable fiduciary obligations and standard of liability.
   3. Uniform Directed Trust Act (UDTA)
      a. In June 2017, the National Conference of Commissioners on Uniform State Law (NCCUSL) approved the Uniform Directed Trust Act, which attempted to address uncertainties surrounding the role and obligations of all types of trust directors, including trust protectors. The Uniform Directed Trust Act can be found at www.uniformlaws.org.
      b. To date, 15 states have enacted the UDTA.
   4. Florida Uniform Directed Trust Act (July 1, 2021)
      a. Effective July 1, 2021, Florida enacted "The Florida Uniform Directed Trust Act" codified in 736.1401-1416 to replace 736.0808 and expand upon the statutory law governing trust protectors and directors. The Florida Act, which was drafted by a subcommittee of the RPPTL Section, is largely based on the Uniform Directed Trust Act.
      b. The Act applies to, among other things, a "power of direction" granted to a trust protector or director under the terms of a trust. A power of direction is defined in 736.0103 to include a power to amend or terminate a trust.
      c. Generally, a protector/director has the same fiduciary duty and liability in the exercise or nonexercised of a power of direction as a trustee in a like position

under similar circumstances. However, the terms of a trust may vary the protector's duty or liability to the same extent the terms of a trust may vary the duty or liability of a trustee in a like position under similar circumstances. Further, the trust may impose additional duties or liability on a protector.

i. The duty of a trustee to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries cannot be eliminated by the trust instrument under 736.0105(2)(b). Therefore, protectors are held to the same minimum duties when exercising a power of direction.
ii. As a result, it is prudent to include language in the trust that provides guidance on the circumstances in which a protector may exercise a power to modify a trust. For example, a trust may state that the protector shall have the right to modify a trust to carry out the settlor's intent in creating the trust and provide a list of the settlor's general intentions, such protecting trust assets from spousal claims and creditors, minimizing taxation, protecting beneficiaries from financial mismanagement or becoming too reliant on the trust funds, and providing for the efficient administration of trust assets. Moreover, consider adding general references to provisions that the protector may modify, such as modifying the administrative or distribution provisions, modifying the factors that the trustee may take into account when making distribution decisions, or modifying provisions to address tax or other legal changes that affect the trust administration.

d. The limitations period to bring a breach of trust action against a protector/director is the same as the period that would apply to a trustee in a like position under similar circumstances under 736.1008. Similarly, the protector/director may assert the same defenses to a breach of trust action that a trustee could assert.
e. Trustees who comply with a power of direction exercised by a protector or director are not liable except to the extent that compliance would result in the trustee engaging in willful misconduct.
f. Since the Florida UDTA is based largely on the UDTA, the comments to the UDTA can be helpful to understanding the Florida UDTA provisions.

5. Caselaw is scarce
   a. *Minassian v. Rachins*, 152 So. 3d 719 (Fla. 4th DCA 2014)
      i. The first published appellate opinion in Florida analyzing the role of a trust protector.
      ii. In *Minassian*, a family trust was set up upon the decedent's death under his revocable trust for the benefit of his surviving spouse during her lifetime. The trust provided that, in making discretionary distributions to the spouse, the trustee is directed to be mindful that Minassian's "primary concern and objective is to provide for the health, education, and maintenance of [his] spouse, and that the preservation of principal is not as important as the accomplishment of these objectives." Further, Article 10 of the trust provided that "the Family Trust shall terminate" at the death of Minassian's spouse, and the remainder distributed as provided in the succeeding Articles. Article 11 stated that it was not Minassian's desire "to create a Common Trust for the benefit of [Minassian's] beneficiaries." Article 12 stated that all trust property not previously distributed shall be divided into a separate trust share for each

of Minassian's children from his prior marriage. Further, the trustee was directed to create a trust share for each beneficiary.

iii. The children, claiming they had standing as qualified beneficiaries of the Family Trust, sued the spouse for breach of fiduciary duties relating to the Family Trust administration.

iv. The spouse argued that the children were not qualified beneficiaries, and did not have standing to sue, because the Family Trust terminates at her death and new trusts are created for the children. Thus, the children are beneficiaries of the new trusts to be created after her death, but not of the Family Trust.

v. After losing at the trial court level, Minassian's spouse exercised the power granted to her under the terms of the trust to appoint Minassian's estate planning attorney as the trust protector. Under the terms of the trust, the protector had the authority to modify or amend the trust, without court authorization, to (i) correct ambiguities that might require court construction or (ii) correct a drafting error that defeats Minassian's intent "as determined by the Trust Protector in its sole and absolute discretion, following the guidelines provided in this Agreement." The trust protector was directed by the trust terms to determine Minassian's intent and consider the interests of current and future beneficiaries "as a whole" and to amend "only if the amendment will either benefit the beneficiaries as a group (even though particular beneficiaries may thereby be disadvantaged), or further [his] probably wishes in an appropriate way." Finally, the trust stated that any exercise of the powers and discretions granted to the trust protector "shall be in the sole and absolute discretion of the Trust Protector, and shall be binding and conclusive on all persons."

vi. The protector exercised his power to amend Article 12 to clarify that it was intended for a new trust to be created after the spouse's death and the children were intended to have shares in the new trust. If valid, the children would not be beneficiaries of the Family Trust and would not have standing to sue.

vii. The children filed a complaint challenging the amendment by the protector.

viii. The court found the trust terms to be ambiguous, that the protector's amendments were made to effectuate the settlor's intent, and that the amendments were within the protector's powers. The court stated that, as the drafting attorney, the protector was privy to what Minassian intended. Ultimately, the Fourth DCA remanded to the trial court with directions that the trust protector's amendments were valid.

ix. The court did not analyze any fiduciary principles as they may have applied to the protector. In contrast, the court seemed to look exclusively at the terms of the trust for the scope of the protector's authority and whether the protector exercised such authority consistent with the authorization provided under the trust.

b. *Robert T. McLean Irrevocable Trust v. Patrick Davis*, P.C., 283 S.W.3d 786 (Mo. Ct. App. S.D. 2009)

i. Attorney J. Michael Ponder represented Robert McLean in obtaining a large recovery for injuries arising out of an automobile accident. The proceeds were put into a special needs trust for the benefit of McLean and Ponder was appointed as the Trust Protector with the power to remove and replace trustees. The trust stated that such authority was conferred to the Trust Protector in a fiduciary capacity, and that the Trust Protector shall not be liable for any action taken in good faith.

ii. When the initial trustees of the special needs trust resigned, the Trust Protector exercised his power under the trust and appointed the law firm of Patrick Davis P.C., Patrick Davis ("Davis") and Daniel Rau ("Rau") as successor trustees of the trust.

iii. McLean and his attorney allegedly informed Ponder in 2000 that the trustees were inappropriately spending trust funds. In July 2001, Davis resigned as trustee, and Ponder appointed Menz to serve as co-trustee. Ponder then resigned as Trust Protector and appointed Gilmore as his successor Trust Protector.

iv. In 2002, Menz resigned as trustee and the beneficiary's mother, Linda, became successor trustee. In 2005, Linda brought an action against the former trustees (Davis, Rau and Menz) as well as Ponder and Gilmore as Trust Protectors, because the trust assets had been significantly depleted.

v. Linda alleged that Ponder breached his fiduciary duties to the trust beneficiary and acted in bad faith because (i) he failed to monitor and report trust expenditures; (ii) he failed to stop the trustees when they were acting against the interests of McLean, and (iii) he placed his loyalty to the trustees and their interests above those of the beneficiary to whom he had a fiduciary obligation.

vi. Ponder responded that he had no duty to monitor or supervise the trustees, but only had those responsibilities stated in the trust, and that no causation could be established.

vii. The court stated that the reference to the Trust Protector's authority being granted "in a fiduciary capacity" under the trust terms suggests that the Trust Protector assumed at least the basic fiduciary duties of undivided loyalty and confidentiality. Further, the statement in the trust that the Trust Protector not be liable for actions taken in good faith implied the existence of at least some duty of care and that no immunity from liability would apply for actions taken in bad faith.

viii. The court found that it was not clear under the trust to whom the fiduciary duty of good faith was owed. Was it to the beneficiary or the trust itself? Further, the court found that the duties and responsibilities that the grantor intended for the Trust Protector were not clearly set forth in the trust and, therefore, there was a genuine issue of material fact.

ix. The appellate court reversed the summary judgment decision of the trial court in favor of Ponder and remanded back to the trial court to determine the duties owed by Ponder as Trust Protector and to whom he owed those duties.

x. In a concurring opinion Judge Parrish was reluctant to concur in the "majority" opinion because the term "trust protector" had not been previously accepted or otherwise defined by statute or court opinion of this state. Judge Rahmeyer, although concurring in the "majority" opinion, observed that she does not "believe it is appropriate for this Court to make up the duties of a trust protector out of whole cloth."

xi. In 2013, the case came back up on appeal. Ultimately, the appellate court found that the Trust failed to prove that any harm or damages resulted from Ponder's alleged breach of fiduciary duty. By reaching this decision, however, it did not become necessary for the court to extensively analyze, or opine on, the fiduciary obligations or responsibilities of a trust protector. *Robert T. McLean Irrevocable Trust u/a/d March 31, 1999 ex rel. McLean v. Ponder*, 418 S.W.3d 482 (Mo. Ct. App. S.D. 2013), reh'g and/or transfer denied, (Nov. 15, 2013) and transfer denied, (Feb. 25, 2014).

V. DECANTING

A. The word "decanting" is used to describe the process by which the trustee appoints or distributes a portion or all of the assets of one trust to one or more other trusts. In effect, a trustee holding a decanting power can modify the terms of a trust by creating a new trust and decanting all of the assets of the existing trust to the new trust.

B. At last count, 36 states currently have decanting statutes.[3] These statutes vary substantially, ranging from one or two sentences to several pages.

1. Why do we care about the decanting laws of the other states?
    a. It is not uncommon for trustees to first figure out what they want to accomplish with a decanting, then change the situs of the trust to a state with a decanting law that permits the goals of the trustee to be accomplished.
    b. Even if a trust is governed by the laws of a state that does not have a decanting statute, changing the situs of the trust to another state could open the door for the trustee to utilize the new state's decanting law.
2. Differences between state laws include:
    a. Notice requirements;
    b. Extent to which the trust terms can be changed in a decanting pursuant to a HEMS distribution power;
    c. Extent to which the trust terms can be changed in a decanting pursuant to an absolute distribution power;
    d. Whether mandatory income interests can be eliminated; and
    e. The extent to which powers of appointment can be granted or altered.

C. Uniform Trust Decanting Act

1. NCCUSL passed July 2015. The Act is available at www.uniformlaws.org.
2. Goals of the Act include:
    a. Provide uniformity among state decanting laws;
    b. Provide common ground for the promulgation of tax guidance on decanting;
    c. Clarify the extent to which charitable trusts may be modified by decanting;
    d. Delineate tax-savings provisions to prevent decanting from unintentionally causing the loss of certain tax benefits, such as the charitable deduction, subchapter S permitted shareholder status, and conduit or accumulation trust status to receive retirement benefits; and
    e. Address areas of uncertainty with decanting, such as the role of courts and the treatment of an imperfect attempted decanting.

[3] For a summary of the state decanting statutes, see https://www.actec.org/assets/1/6/Bart-State-Decanting-Statutes.pdf?hssc=1 prepared by ACTEC Fellow, Susan Bart.

3. Thus far, 12 states have adopted the UTDA. Several other states, such as Florida, did not adopt the UTDA in whole, but used the UTDA as a guide to draft or update their own statutes.

D. Florida
   1. *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940).
      a. Landmark case for Florida common law decanting.
      b. Phipps created a trust for the benefit of her children John, Hubert, Margaret and Michael, with John being the primary beneficiary. Phipps's Spouse and Palm Beach Trust Company were named as trustees. The terms of the trust stated that upon written direction of the individual trustee, which may be contained in his or her last will and testament, the trustees shall pay over and transfer all or any part of the remainder of the trust estate, both principal and income, to Phipps's children and their descendants in such shares and proportions as the individual trustee, in his or her sole and absolute discretion, shall determine and fix even to the extent of directing the payment of the entire trust estate to one of the beneficiaries. The individual trustee exercised such power to direct the transfer of the trust assets into a similar second trust for the benefit of Phipps's descendants, except that John was granted a testamentary power to appoint income in favor of his wife.
      c. The court stated that, based on a review of cases, the general rule 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."
      d. The court stated that, given the settlor's grant of absolute power to the individual trustee and the unlimited discretion to determine the time, amount, manner and condition of any sums that should be paid to the beneficiaries, there could be no doubt of the individual trustee's right to create the second trust for the benefit of one or more of the beneficiaries of the first trust.
      e. The court did not view the creation of the limited power of appointment for John to appoint income in favor of his wife as problematic.
      f. *Phipps* does not discuss any limitations on what may be accomplished in a decanting, nor does it indicate that any notice is required to be given to the beneficiaries; rather, the opinion suggests that such authority is extremely broad. Indeed, the individual trustee in *Phipps* created a limited power of appointment in the primary beneficiary of the first trust that included a permissible appointee who was not even a beneficiary under the first trust.
   2. 736.04117
      a. Originally enacted in 2007 as part of the FTC, but substantially amended in 2018.
      b. Statute permits decanting by trustee pursuant to absolute power or ascertainable standard; however decantings pursuant to an ascertainable standard have additional restrictions. Further, decantings to a supplemental needs trusts are expressly permitted.
      c. Absolute power
         i. Includes a power to invade principal for best interests, welfare, comfort or happiness, or any other power to invade that is not to specific or ascertainable purposes.

ii. Powers of appointment can be created or modified in the second trust, and the class of permissible appointees in the second trust may be different than the class identified in the first trust.
iii. Trust term of second trust may extend beyond term of the first trust
iv. Limitations
   (a) Cannot add new beneficiaries in second trust
   (b) May not reduce any "vested interest". A vested interest is defined as an unconditional right to receive a mandatory distribution of income, a specific dollar amount or percentage of the trust, or an unconditional right to withdraw income, which is not subject to an event, the passage of time or exercise of discretion. For example, a provision to distribute 1/3 of the trust principal when a beneficiary reaches age 35 would be a vested interest <u>if</u> the beneficiary has reached age 35, but not be a vested interest while the beneficiary was under 35. Further, a vested interest does not include a beneficiary's interest in a trust if the trustee has discretion to make a distribution of trust property to a person other than such beneficiary. For example, assume a trust provides for all income to be distributed to A, but permits distributions of principal for any purpose to A or B. A's income interest would not be a vested interest as to any income which is not yet due to A, and could be eliminated in a decanting, because the trustee has authority to distribute all principal to B.

d. Ascertainable standard (the "HEMS decanting")
   i. The beneficial interests of the beneficiaries in the second trust must, in the aggregate, be substantially similar to the beneficial interests in the first trust.
   ii. Powers of appointment in the first trust must be maintained as is in the second trust. The class of permissible appointees cannot be changed and new powers cannot be added.
   iii. The term of the second trust may extend beyond the term of the first trust and, during the extended period, the second trust may grant the trustee absolute power to invade principal and create a power of appointment or expand the class of permissible appointees.
e. Decanting to Supplemental Needs Trust
   i. Permitted whenever a trustee has authority to make current distributions to or for the benefit of a beneficiary with a disability provided the beneficiaries of the second trust include only beneficiaries of the first trust and the trustee determines that the exercise of such power will further the purposes of the first trust.
   ii. Except as to changes to the interest of the beneficiary with a disability, the interests of the beneficiaries in the second trust must, in the aggregate, be substantially similar to their interests in the first trust.
f. Prohibited distributions
   i. Decanting cannot be exercised in a manner that would prevent a contribution from qualifying for, or that would reduce a federal tax benefit, which was originally claimed or could have been claimed, such as qualifying for the gift tax annual exclusion, a marital or charitable deduction, or direct skip treatment under Code § 2642(c).

ii. If S corporation stock is held in the first trust, then the second trust must qualify as a permitted shareholder under Code § 1361(c)(2). Further, if the first trust is a QSST within the meaning of Code § 1361(d), then the second trust must also qualify as a QSST.
iii. If retirement benefits subject to Code § 401(a)(9) are payable to the trust, then the second trust cannot include provisions that would shorten the applicable maximum distribution period.
iv. The trustee may decant assets of the first trust to a second trust regardless of whether the settlor is treated as the owner of either trust under Code §§ 671-679, but if the settlor was not treated as the owner for the first trust then the settlor may not be treated as the owner of the second trust unless the settlor has the power at all time to turn off the grantor trust status of the second trust. This requirement is intended to protect settlors for being forced to pay the income tax on a trust that they previously set up as a non-grantor trust.
v. See 736.04117(7) for additional restrictions on the exercise of the decanting power.

g. Notice
   i. Sixty days advance notice must be given in writing to all qualified beneficiaries and trustees of the first trust, as well as any person (such as a protector) who has the power to remove or replace the trustee intending to perform the decanting.
   ii. If the settlor will be the owner of the second trust under Code § 671-679, then the settlor must be provided notice as well.
   iii. Notice must include the written instrument proposing to exercise the decanting power along with a copy of the first trust and the second trust.
   iv. Statute permits the 60 day notice period to be waived by those who are required to be notified. A simple waiver of the 60 day period should not, however, equate to consent from the beneficiary. Having the beneficiaries consent raises potential gift tax concerns (see Section VII.D. below).
   v. Although not expressly stated in the statute, the expiration of the 60 day period does not appear to terminate the beneficiary's right to bring an action against the trustee relating to the decanting. Rather, the opportunity to bring an action should be governed by the limitations period to challenge trustee actions under 736.1008 (e.g., 6 months after receiving an accounting and limitations notice).

h. Key points about decanting
   i. The settlor can draft to prohibit decanting.
   ii. Only an "authorized trustee" can exercise the decanting power. An "authorized trustee" is defined as a trustee, other than the settlor or a beneficiary, who has the power to invade the principal of a trust.
   iii. Although the exercise of the decanting power is considered the exercise of a limited power of appointment, fiduciary principles, such as the duty of loyalty and impartiality, apply. Thus, just because a trustee has the power to decant does not mean the trustee should, or that the trustee will be absolved of liability for doing so in compliance with the statute. One must consider what changes are to be made as a result of the decanting.

iv. The term "beneficiaries" as used in the statute appears to rely on the definition of "beneficiary" contained in 736.0103(4). Thus, future and contingent beneficiaries are considered for purposes of determining whether the second trust includes only beneficiaries of the first. Section 736.0103(4) states that permissible appointees are not considered "beneficiaries", but if the powerholder has irrevocably exercised the power in favor of a person, then then the person in whose favor the power was exercised is considered a beneficiary.

v. 736.04117 supplements *Phipps* decanting. It does not replace it.
   (a) Thus, when fiduciaries want to decant, but do not want to provide notice to beneficiaries, they may opt for a *Phipps* decanting rather than decanting pursuant to 736.04117.

vi. Despite the 2018 rewrite, 736.04117, practitioners still have some uncertainty on a few decanting issues, such as:
   (a) Can decanting be used to make an amendment to an existing trust or must an entirely new trust be created?
   (b) What is the procedure if a beneficiary objects during the 60 day notice period? Does the failure to object during the 60 day notice period impact the beneficiary's ability to bring an action against the trustee for the decanting after it is completed?
   (c) Is the 60 day notice a trust disclosure document that starts the 6 month limitations period for the beneficiary to object?
   (d) Does a trustee who exercises the decanting power to create a new trust become a "settlor" for purposes of 736.0103 or 736.04117(1)(b)? If so, this would mean that the trustee who decanted assets of the first trust to the second trust is not an "authorized trustee" under the second trust.
   (e) What are the consequences if ineffective notice is given? Is the decanting void?
   (f) The RPPTL Section of The Florida Bar currently has an ad hoc decanting committee studying these issues to determine whether legislative changes should be made to 736.04117

i. Florida caselaw on 736.04117
   i. *Harrell v. Badger*, 171 So. 3d 764 (Fla. 5th DCA 2015).
      (a) Case of first impression on 736.04117. Appears to be the only appellate court decision to date addressing 736.04117.
      (b) Trust provided for all income and discretionary principal distributions for support, maintenance, education, or to meet emergencies of the decedent's son, with the remainder upon the son's death to Harrell and Dake. Trustee decanted assets from the trust to a pooled trust with a sub account for the benefit of decedent's son under the Florida Foundation for Special Needs Trust (FFSNT), which meant that upon Wilson's death, the remaining trust assets would be subsumed into the FFSNT for the benefit of other beneficiaries of the pooled trust.
      (c) The court held that the attempted decanting was invalid because it failed to comply with s. 736.04117. Specifically, the trustee (1) failed to provide notice to the contingent remainder beneficiaries (Harrell and Dake) and (2)

the second trust added FFSNT sub-accounts as contingent beneficiaries, which were not beneficiaries of the first trust.

(d) Query whether the decanting would have been valid under *Phipps*, which does not require notice to beneficiaries. It does not appear from the opinion or appellate briefs that *Phipps* was argued.

E. Tax issues

1. One principal concern with decanting is that the IRS has not issued guidance on the tax consequences associated with decanting.
2. IRS Notice 2011-101 – Treasury and the IRS requested comments from the public on the income, gift, estate and GST tax consequences arising from decanting.
3. For guidance and analysis on the tax issues raised by decanting and the potential resulting tax consequences, see the comments submitted by various professional groups in response to Notice 2011-101.
   i. RPPTL / Tax Section joint comments can be found at: http://floridataxlawyers.org/wp-content/uploads/2015/03/irs-notice-2011-101-tax-section-rpptl-comments-letter-to-irs-re-decanting.pdf
   ii. ACTEC comments can be found at: https://www.actec.org/resources/comments-on-transfers-by-a-trustee/
4. Private letter rulings have been issue by the IRS in the past on decanting transactions. See e.g., PLRs 201711002, 200736002, 200607015, 200227020 and 9737024. However, the IRS has announced that it will not issue additional private letter rulings on the tax consequences of decanting until formal guidance is issued, as contemplated in Notice 2011-101.

VI. TAX CONSIDERATIONS WITH TRUST MODIFICATIONS

A. Binding the IRS

1. Generally, the IRS is not conclusively bound by a modification agreement among the parties or a state court ruling approving the modification to which the IRS is not a party. Therefore, while the parties may draft an agreement referencing certain tax outcomes (e.g., the trust shall pay all parties' attorney's fees and take a deduction on the income tax return), the IRS may reach its own conclusion. Although the property rights of the parties are a matter of state law, the taxation of those property rights is a matter of federal law.
2. The case of *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), is the landmark decision regarding the extent to which the IRS is bound by a state court decision. In *Bosch*, the United States Supreme Court held that, where the federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, federal authorities are not bound by a determination made regarding such property interest by a state trial court. If there is no decision of the highest state court on the issue, then federal authorities must apply what they find to be the state law after giving "proper regard" to the state trial court's determination and to the decisions of other courts of the state. If, however, the highest state court has ruled on the issue, then it should be followed.
   a. The Court recognized that its ruling will require the federal authority, such as the IRS, to sit "as a state court."

b. Based on *Bosch*, a fundamental requirement of any agreement is that it must meet state law requirements and be based on valid rights of the parties under state law.
c. Obtaining trial court approval of a settlement or modification agreement, while common, does not guarantee that the IRS will respect the decision or that the tax result will be consistent with the parties' intentions.

3. The parties have the option to seek a private letter ruling (PLR) from the IRS to confirm the tax consequences of a particular modification, unless the IRS has suspended rulings on the issue. See Rev. Proc. 2018-1. Rulings made by the IRS in the PLR are binding on the parties to whom the ruling is issued, but are not binding on non-parties. There are a plethora of PLRs addressing tax consequences of trust modifications, but parties who rely on a prior PLR issued to another taxpayer to model a modification do so at their own peril. Given the delay and associated cost, PLRs generally are sought only in matters where the tax exposure is significant and the consequences to each party are unclear.
4. Revenue Ruling 73-142 permits taxpayers to obtain a prospective ruling from a state court regarding the taxpayer's rights in a trust which may influence the tax consequences arising from a later event. In Rev. Rul. 73-142, the decedent made gifts to a trust under which the decedent reserved the unrestricted power to remove the trustee at any time and appoint a new trustee. In a non-adversary action, the trial court construed the terms of a trust to mean that the decedent only possessed the right to remove and replace the trustee once, and that this power did not include the right to appoint himself as trustee. After the court's ruling, the decedent exercised such power to remove the original trustee and appoint a new trustee other than himself. Thus, at the time of the decedent's death, the removal and replacement power had been exhausted and the decedent clearly did not possess the power to appoint himself as trustee under state law, which was important for purposes of avoiding Code §§ 2036 and 2038 estate tax inclusion arguments. Even though the decision appeared contrary to those of the highest state court, the IRS ruled that the state court's decision was controlling since the court decree effectively extinguished any claim that the decedent held at the time of his death the power to remove a trustee and appoint himself. In other words, while it may have been unclear whether the grantor possessed such power prior to the court's decision, there was no question that he did not possess the power to appoint himself as trustee after the time to appeal the decision had lapsed. The important distinction with Rev. Rul. 73-142 is that the court's decision was rendered prior to the taxable event occurring, and thus at the time the event occurred, it was clear that the taxpayer did possess the problematic power under state law.

B. Gaining IRS Acceptance
1. If a bona fide dispute does not exist among the trustee(s) and/or beneficiaries at the time of the modification, then transfers among the parties pursuant to a modification are more likely to be deemed to be gifts for transfer tax purposes or a taxable exchange or disposition for income tax purposes.
2. If an actual, bona fide dispute or controversy exists that gives rise to the modification/settlement agreement, then the IRS generally will accept it provided the result to the parties reflects a reasonable outcome that the parties may have received through litigation, taking into account the relative strength of the parties' positions

and the risks and uncertainty of litigation. However, the IRS will not consider a family agreement to be a bona fide compromise agreement unless the parties' claims are (i) bona fide and (ii) satisfied on an economically fair basis. See PLRs 201606002 and 8902045.

a. Requirement of a Bona Fide Dispute
   i. There must be "at least a skirmish between the settling parties," as opposed to simply a "sweetheart contract" *Bel v. US*, 452 F.2d 683 (5th Cir. 1971). Agreements derived from collusive or spurious suits may not qualify as bona fide disputes.
   ii. In *Estate of Allen v. Commissioner*, T.C. Memo 1990-514, the family came to an agreement on its own as to how to divide the assets because they were insufficient to satisfy all of the bequests. The estate was denied a marital deduction for the assets passing to the surviving spouse because the Tax Court found no persuasive evidence of a family conflict. Absent a bona fide controversy, the property did not pass from the decedent to the surviving spouse but rather, it passed by agreement among the parties.
   iii. Practice Tip: Agreements resulting in a modification should recite the bona fide dispute that exists between the parties and the basis for each party's claim.
b. Economically Fair Basis
   i. If the IRS finds that a bona fide dispute existed, it may still scrutinize the values exchanged or received by the parties in the settlement to ensure that one or more parties did not receive substantially more than they would have if the litigation had been pursued to a judgment. See Rev. Rul. 83-107. Further, the IRS may also look at the character of the interests received in the settlement in relation to the interests at issue in litigation. See *Estate of Hubert v. Commissioner*, 101 T.C. 314 (1993); and PLR 9716011.
   ii. Generally, the IRS will accept agreements that are within the range of reasonable outcomes that the parties may have obtained through litigation, after giving appropriate regard to allowances for the risks and uncertainty of litigation.

C. Income Tax Considerations
1. General Rules for Trust Distributions
   a. Income tax of trusts is based on a conduit principle – "He who gets the income pays the tax."
   b. Distributable Net Income (DNI)
      i. DNI is comprised of taxable income items earned on trust assets, subject to certain modifications. Code § 643(a).
      ii. DNI is the measuring rod for determining the amount of a distribution from a trust that is deductible from income to the trust and includible in income of the beneficiary. To the extent DNI is retained in the trust at the end of the tax year, it is generally taxed to the trust for income tax purposes. To the extent DNI is in the hands of a beneficiary at the end of the tax year, it is generally taxed to the beneficiary for income tax purposes.
      iii. Trusts generally receive an income tax deduction for DNI distributed to a beneficiary.

iv. Beneficiaries generally include distributions in gross income to the extent they are comprised of DNI.
v. Code § 663(a) excludes from the gross income of a beneficiary any amounts which, under the terms of the governing instrument, are properly paid or credited as a gift or bequest of a specific sum of money or of specific property and which is paid or credited all at once or in not more than 3 installments.

c. Gifts or inheritances are not gross income
   i. Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. Code § 102(a). However, *income* from any such property, or a gift, bequest, devise, or inheritance *of income* is not excluded from gross income. Further, any amount included in the gross income of a beneficiary under subchapter J (i.e., the rules governing the income taxation of estates and trusts) shall be treated as a gift, bequest, devise, or inheritance *of income* from property, which means it is not excluded from gross income under Code § 102.

2. Exchange of Property for Other Property Differing Materially in Kind
   a. The test to determine whether a modification results in a disposition for income tax purposes under Code § 1001 is whether the interests exchanged are "materially different in kind or extent." *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991).
      i. In *Cottage Savings*, the Supreme Court ruled that properties are materially different if their owners "enjoy legal entitlements that are different in kind or extent." Id. at 555. Thus, one must compare the legal entitlements before and after the modification. This test has been applied by the IRS in numerous private letter rulings.
   b. The gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. See Treas. Reg. § 1.1001-1.
3. Non-Pro Rata Distributions
   a. If a trust makes unauthorized non-pro rata distributions of property to its beneficiaries (meaning non-pro rata distributions are not authorized under the terms of the governing instrument or local law), the IRS has ruled that the distributions are equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries. This deemed exchange will be taxable to both beneficiaries to the extent that values differ from basis. Rev. Rul. 69-486, 1969-2 CB 159.
4. In Kind Distributions
   a. Generally, the amount of DNI carried out by an in-kind distribution to a beneficiary is the lesser of the adjusted basis of the property prior to distribution, or the fair market value of the property at the time of the distribution. Code § 643(e). Subject to some exceptions, a trust does not recognize gain or loss as a result of making a distribution to a beneficiary.

i. If a trust satisfies a pecuniary (dollar amount) bequest with property, the payment is treated as a sale or exchange of property by the trust, requiring the trust to recognize gain or loss. See *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940).

ii. Distributions to creditors that satisfy a pecuniary obligation of the trust are recognition events for the trust. The fair market value of the property is treated as being received by the trust as a result of the distribution; therefore, the trust will recognize gain or loss if the trust's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. For example, if a trust agrees to pay a debt of $100,000 pursuant to a settlement agreement, and transfers an asset worth $100,000 with a basis of $80,000 in satisfaction of the debt, the trust will recognize a $20,000 gain.

iii. If an election pursuant to Code § 643(e)(3) is made by the fiduciary, gain or loss shall be recognized by the trust in the same manner as if such property had been sold to the distributee at its fair market value and the amount taken into account under Code §§ 661(a)(2) and 662(a)(2) shall be the fair market value of such property. The beneficiary will take a basis in the property received equal to the fair market value of the property on the date of distribution. The election applies to all in kind distributions made by the trust during the taxable year for which it is made. Once made, the election for that taxable year can be revoked only with the consent of the Treasury. Code § 643(e).

5. Disposition of Term Interests
   a. A term interest is defined as (i) a life interest in property, (ii) an interest in property for a term of years, or (iii) an income interest in a trust. Treas. Reg. § 1.1001-1(f)(2).
   b. Pursuant to Code § 1001(e), the adjusted basis of the holder of the term interest in property determined under Code §§ 1014 (inheritance), 1015 (gift) or 1041 (transfers between spouses) is disregarded. Therefore, the holder of the term interest will have gain recognition upon a disposition equal to the entire value of the term interest *unless* the term interest is part of a single transaction in which the entire interest in property is transferred to a third person or to two or more persons. Treas. Reg. § 1.1001-1(f).
   c. Example - Securities worth $500,000 at the date of decedent's death on January 1, 2017, are bequeathed to his wife, W, for life, with remainder over to decedent's son, S. W is 48 years of age when the life interest is acquired. By reference to Treas. Reg. § 20.2031-7A(c), the life estate factor for age 48, female, is 0.77488 and the remainder factor for such age is 0.22512. Therefore, the present value of the portion of the uniform basis assigned to W's life interest is $387,440 ($500,000 x 0.77488), and the present value of the portion of the uniform basis assigned to S's remainder interest is $112,560 ($500,000 x 0.22512). W sells her life interest to her nephew, A, on February 1, 2017, for $370,000, at which time W is still 48 years of age. Pursuant to Code § 1001(e), W's gain is $370,000, the amount realized from the sale. A has a basis of $370,000. See Treas. Reg. § 1.1014-5(d), Ex. 1.

d. The character of gain to the life tenant is to be treated as an amount realized from the sale or exchange of a capital asset. See *McAllister v. Commissioner*, 157 F. 2d 235 (1946); Rev. Rul. 72-243.
e. If the property interest was held for more than one year, then the gain or loss should be taxed as long-term capital gain or loss; if the property was held for less than one year, then it should be taxed as short-term capital gain or loss. See Code §§ 1222(1)-(4).
f. The remainder beneficiaries should receive a carryover basis in assets received. Treas. Reg. § 643(e).

6. Severance of Trusts
   a. In general, the severance of a trust is not an exchange of property for other property differing materially in either kind or extent if (i) the severance is permitted by the trust or state statute, and (ii) any non-pro rata funding is authorized by state law or the trust terms. See Treas. Reg. § 1.1001-1(h).
      i. Note that 736.0816(22) permits trustees to make non-pro rata distributions.
   b. If the trustee does not have authority to make non-pro rata distributions, but does so in the severance process anyways, the distributions to the resulting trusts would be treated as a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the resulting trusts. The *Cottage Savings* test is then applied to determine whether the legal entitlements of the trusts' interests before and after the severance are materially different in kind or extent. If so, a taxable disposition has likely occurred for income tax purposes.

D. Gift Tax Considerations
   1. Amounts Received in Trust Modifications
      a. Consent by a beneficiary to a modification agreement that results in some or all of the beneficiary's beneficial interest in a trust or estate being transferred to another beneficiary can result in a taxable gift.
         i. Treas. Reg. § 25.2511-1(a) provides that "[t]he gift tax applies to a transfer by way of gift whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible."
         ii. Treas. Reg. § 25.2511-1(c)(1) provides that "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax."
         iii. Treas. Reg. § 25.2511-1(g)(1) provides that "[a] transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee (but such a transfer may constitute a gift by the creator of the trust, if until the transfer he had the power to change the beneficiaries by amending or revoking the trust)."
      b. However, Treasury Regulation § 25.2512-8 contains what is commonly referred to as the "ordinary course of business exception", which states that 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 donative intent) will be considered as made for an adequate and full consideration in money or money's worth. Parties to a modification often attempt to rely on this exception

to avoid gift tax consequences. Family transactions relying on this exception will be closely scrutinized. See *Redstone v. Commissioner*, T.C. Memo 2015-237.

   c. A transfer of property by an individual in settlement of litigation generally is treated as a transfer for full and adequate consideration in money or money's worth and therefore not a gift for federal gift tax purposes.
   d. In determining whether full and adequate consideration has been received in family disputes, the courts have analyzed various factors including the following:
      i. Whether a genuine controversy existed between the parties;
      ii. Whether the parties were represented by and acted upon the advice of counsel;
      iii. Whether the parties engaged in adversarial negotiations;
      iv. Whether the value of the property involved was substantial;
      v. Whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and
      vi. Whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. See, e.g., *Estate of Natkanski*, T.C. Memo 1992-380 (1992); *Estate of Friedman v. Commissioner*, 40 T.C. 714.
2. Disposition of Life Estate Interest in QTIPs
   a. Modifications involving property qualifying for the marital deduction under Code § 2056(b)(7) or Code § 2523(f) as qualified terminable interest property ("QTIP") should be handled with extreme care to ensure that the modification of such property does not result in a disposition of the QTIP property. The initial transfer that created the QTIP property was exempt from transfer tax on the theory that interspousal transfers should not be subject to transfer tax, but such tax is merely deferred and will be incurred upon a subsequent disposition of the property under Code § 2519 (during life) or 2044 (at death).
   b. Code § 2519 Disposition of certain life estates
      i. If a donee spouse disposes of all or any interest in QTIP property, Code § 2519 treats the donee spouse as making a deemed gift of all interests in the property other than the qualifying income interest. If the qualifying income interest is transferred as well, then such transfer will be deemed an additional gift pursuant to Code § 2511. Further, the spouse is also treated as making a transfer for estate tax purposes, which means Code § 2036 could apply if the spouse retains an income interest in the portion of the principal that is deemed to have been transferred under Code § 2519 or § 2511. See Treas. Reg. § 25.2519-1(a).
      ii. Amount of deemed transfer under Code § 2519
         (a) The amount treated as a transfer under Code § 2519 is equal to the fair market value of the entire property subject to the qualifying income interest, determined on the date of the disposition (including any accumulated income and not reduced by any amount excluded from total gifts under Code § 2503(b) with respect to the transfer creating the interest), less the value of the qualifying income interest in the property on the date of the disposition. See Treas. Reg. § 25.2519-1(c)(1).
         (b) Amount of gift is reduced by the amount of gift tax the donee spouse is entitled to recover pursuant to Code § 2207A. The amount of gift tax the spouse is entitled to recover under Code § 2207A is deducted from the

amount transferred to arrive at the amount subject to tax under Code § 2519, resulting in a net gift. See Treas. Reg. § 25.2519-1(c)(4).

(c) If the transferor spouse fails to exercise the Code § 2207A right of recovery, the transferor is treated as making an additional gift of the amount to which the transferor was entitled to recover. See Treas. Reg. § 25.2207A-1(b).

iii. Conversion of QTIP property into other property

(a) The conversion of QTIP property into other property in which the donee spouse has a qualifying income interest for life is not, for purposes of Code § 2519, treated as a disposition of the qualifying income interest. Similarly, the sale of real property in which the spouse possesses a legal life estate meeting the requirements of QTIP property, followed by the transfer of the proceeds into a trust which also meets the requirements of QTIP, or by the reinvestment of the proceeds in income producing property in which the donee spouse has a qualifying income interest for life, is not considered a disposition of the qualifying income interest.

(b) However, the sale of QTIP property, followed by the payment to the donee spouse of a portion of the proceeds equal to the value of the donee spouse's income interest, is considered a disposition of the qualifying income interest. See Treas. Reg. § 25.2519-1(f).

c. Code § 2511 Disposition of the qualifying income interest

i. A transfer of all or a portion of the qualifying income interest of the spouse for less than fair market value is a transfer by the spouse under Code § 2511. See Treas. Reg. § 25.2519-1(a).

ii. Sale of qualifying income interest for fair market value is not a gift under Code § 2511 because the consideration received for spouse's income interest is equal to the value of the income interest. See Treas. Reg. § 25.2519-1(g) Ex 2. See also Field Service Advice 199916025 (transfer of qualifying income interest was part of consideration for arm's length agreement and was not a gift).

iii. The sale of an income interest by the spouse to settle claims to a QTIP pursuant to settlement agreement is not a gift of the income interest under Code § 2511, but a gift will still be deemed to result pursuant to Code § 2519 in an amount equal to the entire value of the QTIP Trust less (a) the value of the qualifying income interest, (b) the amount paid to the spouse for the release of the spouse's interest in the trust principal and (c) the amount of the gift tax that the spouse may recover pursuant to Code § 2207A. See PLRs 200027001 and 200027002.

iv. The fair market value of the qualifying income interest is generally determined for tax purposes based on the Section 7520 rate in effect at the time and the age of the income interest holder.

d. Severance of QTIP Trust.

i. To minimize the risk of unintended consequences where less than the entire QTIP Trust is at issue, consider severing the QTIP Trust first into separate trusts and then modifying only the particular QTIP Trust that is at issue. Based on PLRs issued by the IRS (which, as a reminder, are not binding authority on the IRS except to the taxpayer who receives the PLR), the disposition of a qualifying income interest in only one of the resulting trusts should not trigger a deemed disposition under Code § 2519 of the other trust(s) resulting from the severance. See PLR 200328015.

ii. If a surviving spouse dies within 3 years of the termination of a QTIP Trust Code § 2035(b) brings gift tax paid back into surviving spouse's estate for estate tax purposes. See *Estate of Anne Morgens v. Commissioner*, 678 F.3d 769, 776 (9th Cir. 2012).

3. Avoiding unintended gifts is critical in trust modification actions. If there is a deemed transfer for gift tax purposes, then depending on the modifications made to the trust, these transfers could also trigger estate tax concerns, such as inclusion under Code § 2036, GST tax concerns, and even state law creditor protection concerns (if the resulting trust is deemed to be a self-settled trust for the benefit of the beneficiary deemed to have made the gift).

E. Estate Tax Considerations

1. When modifying a trust, always consider whether the initial transfer of assets to the trust qualified for a tax benefit, such as the marital deduction or charitable deduction. If it does, then modifying the trust in a manner that would eliminate the availability of the deduction could have significant consequences.
2. Code § 2056 Marital Deduction

a. To receive a marital deduction under Code § 2056 for assets received from a decedent, the property interest at issue must be deemed to have "passed from the decedent" to the surviving spouse, and the interest cannot be a non-deductible terminable interest.

i. In the context of family trust settlements and modifications arising from disputes concerning a decedent's estate planning documents, it is important to ensure that the property interest received by the surviving spouse satisfies the "passing" requirement. If it does not, then a marital deduction will not be allowed.

ii. Treas. Reg. § 20.2056(c)-2(d)(1) provides that "[i]f as a result of a controversy involving the decedent's will, or involving any bequest or devise thereunder, his surviving spouse assigns or surrenders a property interest in settlement of the controversy, the interest so assigned or surrendered is not considered as having passed from the decedent to his surviving spouse."

iii. Treas. Reg. § 20.2056(c)-2(d)(2) provides as follows:

> If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent" to his surviving spouse only if the assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. However, such a decree will be accepted only to the extent that the court passed

upon the facts upon which deductibility of the property interests depends. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.

b. Enforceable Right under State Law
    i. Do not assume that the property received or paid in a settlement will automatically be deemed to have "passed" from the decedent to a person pursuant to a settlement agreement. Failing to satisfy the passing requirement can result in the property generating estate tax regardless of who receives it.
    ii. The Supreme Court in *Bosch* held that the "test of 'passing' for estate tax purposes should be whether the interest reaches the spouse pursuant to state law, correctly interpreted [by the federal court]—not whether it reached the spouse as a result of a good faith adversary confrontation." *Estate of Brandon v. C.I.R*, 828 F.2d 493, 497 (8th Cir. 1987) (citing Bosch at 774).
    iii. In *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981), the Ninth Circuit held that property distributed to a spouse pursuant to a settlement will be treated as passing from the decedent for marital deduction purposes only if the distribution represents a good faith settlement of an enforceable claim. Relying on *Bosch*, the court stated that "either a good faith settlement or a judgment of a lower state court must be based on an enforceable right under state law properly interpreted, in order to qualify as 'passing' pursuant to the estate tax marital deduction." *Ahmanson Foundation* at 775 (emphasis added).
    iv. When a settlement affects the amount of estate tax due, the IRS or federal court is not required to accept the terms of the settlement agreement and may re-examine the underlying state law issue de novo. See *Bosch* at 774.

3. Code § 2055 Charitable Deduction
    a. Code § 2055 permits an unlimited deduction for qualifying bequests made to charities.
    b. The bequest or devise to the charity must be deemed to have "passed from the decedent" in order for the charitable deduction to be available. With respect to amounts received as a result of a settlement or modification arising from a dispute, the same principles that apply to determine "passing from the decedent" for marital deduction purposes, as described above (i.e., an enforceable right under state law properly interpreted), apply for charitable deduction purposes. See e.g., PLR 9812014.
        i. Treas. Reg. § 20.2055-2(e)(1)(i) states: "The principles of Code § 2056 and the regulations thereunder shall apply for purposes of determining under this paragraph (e)(1)(i) whether an interest in property passes or has passed from the decedent."
    c. The amount of the deduction is limited to the amount required to be included in the gross estate. Code § 2055(d). Further, the deduction may not exceed the amount that the charity actually receives under the settlement agreement. *Irving Trust Company v. U.S.*, 221 F. 2d 303 (2d Cir. 1955).

d. If a charity's interest is contingent upon an event to occur, the charitable deduction is not available "unless the possibility that the charitable transfer will not become effective is so remote as to be negligible." Treas. Reg. § 20.2055-2(b)(1).
e. Be careful in structuring payments to, or trusts for the benefit of, charities. Only outright payments to charities and transfers made to certain split interests trusts qualify for the estate and gift tax charitable deductions. If a deductible transfer is made to a split interest trust, then the deduction is limited only to the portion of the interest that passes to the charity in the form of a guaranteed annuity interest or unitrust interest in a charitable lead trust or a remainder interest in a charitable remainder interest that meets the requirements of Code § 664(d). Code §§ 2055(e)(2) and 2522(c).
f. The IRS will scrutinize settlements involving charitable interests to confirm that the litigation was not collusive or instituted merely to obtain the charitable deduction. See Rev. Rul. 89-31.
g. Qualified Reformation
    i. If the interest passing from a decedent to a trust for the benefit of a charity does not qualify for an estate tax charitable deduction because the terms of the recipient trust do not satisfy the requirements of a deductible charitable lead trust or charitable remainder trust, Code § 2055(e) permits the trust to be reformed within a limited period of time after the decedent's death in a manner that will result in the transfer becoming a deductible qualified interest in certain circumstances.
    ii. See Code § 2055(e) for various requirements.

F. GST Tax Considerations
1. Background
    a. Practitioners and parties to a trust modification or settlement agreement must be cognizant of the generation skipping transfer ("GST") tax implications that may arise as a result of changes to the trust terms and the beneficial interests of the beneficiaries. The issues include:
        i. Whether a payout to a beneficiary will be considered a generation-skipping transfer and incur a GST tax;
        ii. Will the changes to the trust create a generation-skipping transfer at some point in the future?
        iii. Will the changes to the trust alter the exempt status (i.e., the inclusion ratio) of the trust?
        iv. Is any beneficiary deemed to have made a constructive addition to the trust? If so, should such beneficiary allocate his or her GST exemption to the transfer?
        v. Will contributions to the resulting trust attract an automatic allocation of the transferor's GST exemption under Code § 2632?
        vi. Have the GST benefits of the trust been harmed, for example, by eliminating GST exempt transfers that would otherwise have been made under the prior terms of the trust?
    b. Given the complexity of the GST tax, the parties may want to condition a modification on a favorable private letter ruling from the IRS to confirm that the

modification will not alter the GST exempt trust status of the trust. There are a plethora of PLRs addressing the GST consequences in trust modifications. See e.g., PLRs 201803003, 201732029, 201723003, and 201723002.

2. Grandfathered GST Trusts
   a. Treasury regulation § 26.2601-1(b)(1)(i) states that the GST tax does <u>not</u> apply to "any generation-skipping transfer under a trust that was irrevocable on September 25, 1985." However, this exclusion "does not apply to a pro rata portion of any generation-skipping transfer under an irrevocable trust if additions are made to the trust after September 25, 1985." *Id*.
   b. If an addition is made after September 25, 1985 to a grandfathered GST trust, then the trust is thereafter deemed to consist of two portions, one portion of the trust that is not subject to GST tax (the GST Exempt portion) and one portion that is subject to GST tax (the GST non-exempt portion). Each portion has a separate inclusion ratio. Treas. Reg. § 26.2601-1(b)(1)(iv)
   c. Treas. Reg. § 26.2601-1(b)(4)(i) provides rules for determining when a decanting, settlement, judicial construction or other modification action with respect to a trust that is exempt from the GST will not cause the trust to lose its exempt status. By its strict terms, this regulation only applies to grandfathered GST exempt trusts. This regulation does not state that the same rules will apply to a trust that is GST exempt as a result of an allocation of exemption by a transferor. Further, no rules have been promulgated for trusts exempt as a result of an allocation of GST exemption. The IRS, however, has ruled in several private letter rulings that, at a minimum, a modification that does not affect the exempt status of a grandfathered GST exempt trust should similarly not affect the inclusion ratio of a non-grandfathered trust that is exempt as a result of the allocation of GST exemption. See, e.g. PLR 200822008. Therefore, the rules under Treasury Regulation § 26.2601-1(b)(4)(i) provide the best guidance currently available for trusts that are exempt as a result of an allocation of GST exemption.
3. Decanting
   a. Treas. Reg. § 26.2601-1(b)(4)(i)(A) provides safe harbor requirements to preserve GST exempt status in the case of decanting:
      i. Either the terms of the exempt trust authorize distributions to the new trust or the retention of principal in a continuing trust, without the consent or approval of any beneficiary or court, or at 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 of any beneficiary or court; <u>and</u>
      ii. The terms 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.
         (a) Postponing or suspending the vesting or absolute ownership of an interest for a term of years that will not exceed 90 years is expressly permitted.

   b. *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940) appears to be the first case authorizing decanting in Florida, which was well before the enactment of 736.04117.
   c. If the proposed decanting will not meet the safe harbor requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(A), it may still be possible to meet the safe harbor requirements under Treas. Reg. § 26.2601-1(b)(4)(i)(D) for a modification (see below) to preserve GST exempt status.
4. Court Approved Settlement Agreements
   a. Treas. Reg. § 26.2601-1(b)(4)(i)(B) provides that 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 a GST exempt trust to become a non-exempt GST trust, if:
      i. The settlement is the product of arm's length negotiations; <u>and</u>
      ii. The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.
5. Judicial Construction
   a. Treas. Reg. § 26.2601-1(b)(4)(i)(C) provides a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause a GST exempt trust to become a non-exempt GST trust if:
      i. The judicial action involves a bona fide issue; <u>and</u>
      ii. The construction is consistent with applicable state law that would be applied by the highest court of the state.
6. Other Changes
   a. Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1) provides that a modification of the governing instrument of a GST exempt trust (including a trustee distribution, settlement, or construction that does not satisfy Treas. Reg. § 26.2601-1(b)(4)(i)(A) or (B) or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause a GST exempt trust to become a non-exempt GST trust, if:
      i. The modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in Code § 2651) than the person or persons who held the beneficial interest prior to the modification, <u>and</u>
      ii. The modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.
   b. Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2) states as follows:
      i. A modification of a GST exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.

ii. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification.
iii. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in Code § 2651) than the person or persons who held the beneficial interest prior to the modification.
iv. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust.
v. Administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of Treas. Reg. § 1.643(b)-1 of this chapter.

7. Qualified Severance:
   a. Code § 2642(a)(3)(B) and the regulations thereunder provide rules for the qualified severance of a single trust, which is partially or wholly exempt from GST tax, into two or more trusts which are treated as separate trusts for GST tax purposes. If the requirements of a qualified severance are satisfied, then the parties severing the trust can segregate the exempt portion and the non-exempt portion into separate trusts so that the administration and distributions of one trust will not impact the administration and distribution of the other.
      i. If the original trust is either wholly exempt or wholly non-exempt, then the resulting trusts will have the same inclusion ratio as the original trust.
      ii. If the original trust is partially exempt (meaning that the inclusion ratio is between zero and one) and severed into two trusts, then one trust arising from the severance will be entirely exempt and the other trust will be entirely non-exempt.
      iii. If the original trust is partially exempt, and severed into more than two trusts, then the exempt portion will be allocated to one or more resulting trusts which are entirely exempt and the non-exempt portion will be allocated to one or more resulting trusts which are non-exempt. At the end of the day, each resulting trust must have an inclusion ratio of zero or one.
   b. The requirements for a Qualified Severance are as follows:
      i. The single trust is severed pursuant to the terms of the governing instrument <u>or</u> pursuant to applicable local law;
      ii. Severance is effective under local law;
      iii. Funding must occur within 90 days of severance date;

iv. Original trust is severed on a fractional basis, such that each resulting trust is funded with a fraction or percentage of the original trust and the aggregate of those fractions or percentages is one or one hundred percent, respectively; and

v. Resulting trusts must provide for same succession of interests of beneficiaries as the original trust.

   (a) This requirement is satisfied if the beneficiaries or the separate resulting trusts and the interests of the beneficiaries with respect to the separate trusts, when the separate trusts are viewed collectively, are the same as the beneficiaries and their respective beneficial interests with respect to the original trust before severance.

   (b) With respect to trusts from which discretionary distributions may be made to one or more beneficiaries on a non-pro rata basis, then the beneficiaries will be deemed to have the same succession of interests if:

      1. The terms of the resulting trust are the same as the original trust (even if each permissible distributee of the original trust is not a beneficiary of all resulting trusts);
      2. Each beneficiary's interest in the resulting trusts collectively equals the beneficiary's interest in the original trust, determined by the terms of the trust instrument or, if none, on a per-capita basis;
      3. The severance does not shift a beneficial interest to a beneficiary in a lower generation; and
      4. The severance does not extend the time for vesting of any beneficial interest beyond the time provided for in the original trust.

VII. Exhibits

A. Case Study #1 – Severance and Modification: Divide and Conquer
B. Case Study #2 – Decanting

CASE STUDY #1 – DIVIDE AND CONQUER

Ned dies survived by his wife, Catelyn, and his daughters, Sansa and Arya. Ned leaves a credit shelter trust that provides for discretionary distributions to Catelyn for HEMS during her lifetime and, upon her death, it splits into separate dynasty trusts for Sansa and Arya. The credit shelter trust owns $1 million of gold, $2 million of property, and a 100% interest in a sword fighting business (that Arya now manages) valued at $2 million. Arya, being a gifted businesswoman and master sword fighter, expects to double the value of the business over the next 5 years, now that she is in control and can teach the art of sword fighting the way she wants to. Arya hates the idea that her efforts to enhance the business will benefit Sansa and Sansa's descendants when Catelyn dies. Sansa is not impressed with Arya's skills and wants nothing to do with the business. Further, she does not want her future inheritance to be harmed when the business fails. Thus, Sansa is demanding the trustee sell the business. Upon Catelyn's death, if not before, there is sure to be a fight (possibly even a sword fight?) between Sansa and Arya regarding the division of the trust assets, primarily as a result of the growth or decline of the business. What can be done to save the Stark family?

1. Proposed Solution: Sever credit shelter trust into two trusts and modify the trust provisions:
    a. Trust 1: For the benefit of Catelyn and, upon her death, Sansa and descendants
        i. Fund with $500k of gold and $2m of property
    b. Trust 2: For the benefit of Catelyn and, upon her death, Arya and descendants
        i. Fund with $500k of gold and $2m business

2. Benefits of Severance and Modification
    a. Each Trust has assets of $2.5 million.
    b. Only Catelyn, Arya and her descendants will share in the success or failure of the business. The share for Sansa and her descendants is not affected by the performance of the business.
    c. Each Trust has assets that, with Catelyn's consent, can be independently invested without the consent of the other child.
    d. Agreement can be made between Catelyn, Arya and Sansa that distributions for Catelyn will be made equally from Trust 1 and Trust 2.

3. Settlement Options
    a. Severance
        i. Fla. Stat. § 736.0417
    b. Judicial Modification
        i. Fla. Stat. § 736.04113 – Modification because of unanticipated circumstances
            1. Dispute has arisen and continuing trust on the same terms would lead to depletion of trust assets on litigation expenses instead of preserving the assets for the benefit of the beneficiaries.

ii. Fla. Stat. § 736.04115 – Modification for best interests of beneficiaries

1. Compliance with the existing provisions is not in the best interests of the beneficiaries because it will lead to further disputes and unnecessary trust administration expenses. It is in the best interests of the beneficiaries to sever the trust into two trusts to avoid further disputes.

c. Nonjudicial Modification

i. Fla. Stat. § 736.0412 – Consent of trustee and qualified beneficiaries

ii. Fla. Stat. § 736.0111 – Nonjudicial Settlement Agreement to modify the trust in the same manner that a court would under § 736.04113 and 736.04115 may be possible.

4. Income Tax Considerations

a. Concern: The exchange of interests by Sansa and Arya could be treated as a sale or exchange under Code § 1001 leading to the recognition of gain or loss.

i. Treas. Reg. § 1.1001-1(h) – severance is not a taxable exchange if the severance was permitted by the trust or state law, and any non-pro rata funding is authorized by the trust or state law.

ii. If non-pro rata funding is not authorized by the trust terms or state law, then the severance generally will be treated as a pro rata distribution of assets followed by a taxable exchange of assets between the resulting trusts. Note that Fla. Stat. § 736.0816(22) authorizes non-pro rata funding.

iii. Treas. Reg. § 1.1001-1; *Cottage Savings Assoc. v. Commissioner*, 499 U.S. 554 (1991)

1. Gain or loss is realized from the exchange of property under Code § 1001 only if the interests exchanged are "materially different either in kind or extent".

2. The key question is whether the exchanged properties "embody legally distinct entitlements." Thus, one must compare the legal entitlements of each party before and after the modification to determine if the property exchanged is materially different than the property received.

5. Estate Tax Considerations

a. Should not be a concern as long as the parties are not deemed to have made contributions to the resulting trusts. If a beneficiary is deemed to have made a gift to his or her trust as a result of the severance, then Code § 2036 arguably may apply.

6. Gift Tax Considerations
   a. Concern: Sansa or Arya could be treated as making a gift to the other by relinquishing their beneficial interest in the other's trust.
      i. IRC § 2511 – Gift is deemed to be made to the extent the modification shifts value from one beneficiary to the other.
      ii. Settlements resulting from bona fide disputes/litigation should be deemed transfers for full and adequate consideration, and thus, not a gift. See *Ahmanson Foundation v. U.S.*, 674 F.2d 761 (9th Cir. 1981) (Intrafamily settlements will not be regarded as a bona fide compromise unless the claims were legitimate and are satisfied, to the extent feasible, on an economically fair basis).

7. GST Tax Considerations
   a. Concern: The creation of two new trusts could adversely impact the GST exempt status of the assets of the original trust.
      i. Preserve GST upon Severance - Treas. Reg. § 26.2642-6 Requirements of a Qualified Severance:
         1. Must be pursuant to state law or trust terms;
         2. Effective under local law;
         3. Funding must occur within 90 days of severance date;
         4. Original trust is severed on a fractional basis; and
         5. Resulting trusts must provide for same succession of interests of beneficiaries as the original trust.
      ii. Preserve GST upon Modification
         1. Treas. Reg. § 26.2601-1(b)(4)(i)(D) - A modification of the governing instrument of an exempt trust by judicial or nonjudicial reformation that is valid under applicable state law will not cause an exempt trust to be subject to GST tax if (a) the modification does not shift a beneficial interest in the trust to a beneficiary who occupies a lower generation than the person(s) who held the beneficial interest prior to the modification, and (b) the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.
         2. Treas. Reg. § 26.2601-1(b)(4)(i)(B) - 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 GST tax if the settlement is (a) the product of arm's length negotiations and (b) within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.
      iii. Note: Although the regulations under Treas. Reg. § 26.2601-1(b)(4) technically apply to grandfathered GST exempt trusts, numerous private letter rulings have applied these standards to

trusts that were exempt by virtue of the allocation of GST exemption.

CASE STUDY #2 – DECANTING

Tywin created an irrevocable trust that provides for distributions to or for the benefit of his daughter Cersei and Cersei's descendants for HEMS. In addition, a disinterested/independent trustee may make distributions for Cersei and Cersei's descendants for their best interests. The trust provides that 1/3 of the assets shall be distributed to Cersei once she reaches age 45, 1/2 shall be distributed once Cersei reaches age 50, and all remaining assets shall be distributed to Cersei once she reaches age 55. If Cersei dies prior to receiving all of the Trust assets, then the balance is distributed outright to Cersei's descendants, per stirpes.

Cersei is currently 43 and has two adult descendants, Joffrey and Tommen. Tywin did not allocate any GST exemption to the trust.

The trust investments have grown larger than Tywin anticipated and he does not want Cersei or Cersei's descendants to receive large distributions of the trust assets outright at any age. He has concerns that Cersei, Joffrey and Tommen may lose the motivation to rule the Seven Kingdoms and further the family's wealth if they receive a lump sum distribution from the trust. Joffrey and Tommen are not happy with distributions the trustee has been regularly making for Cersei because they feel that "mom doesn't need the money" and she is wasting it, mostly on security guards. They are concerned that there will not be any money left for them because Cersei is the only one receiving distributions currently and the entire remaining balance is scheduled to be distributed to Cersei when she reaches 45/50/55. What can be done?

1. Proposed Solution: Decanting to one or more new trusts that eliminate mandatory principal distributions at certain ages and ensure assets are earmarked for Joffrey and Tommen.
    a. Fla. Stat. § 736.04117.
        i. Expressly permits the extension of the trust term
        ii. Cersei's right to receive assets at 45, 50 and 55 is not a vested interest, and thus can be eliminated through decanting, because (1) such distributions are contingent upon her surviving to the stated ages and (2) the independent trustee has the authority to invade principal for Cersei's descendants
    b. 32 states have decanting statutes.
    c. Uniform Trust Decanting Act approved in 2015.

2. General Tax Considerations
    a. IRS Notice 2011-101 (December 21, 2011) – IRS requested comments regarding the circumstances under which transfers by a trustee of all or a portion of the principal of one irrevocable trust to another irrevocable trust that result in a change in the beneficial interests in the trust are not subject to income, gift, estate or GST taxes.
    b. IRS has yet to issue final guidance and will not issue private letter rulings in the meantime. Therefore, the tax consequences of decanting are not settled.

c. Several practitioners have published articles analyzing the tax issues associated with decanting.
d. General argument is that decanting should not be a taxable event to the beneficiaries because it is the result of the exercise of a trustee's fiduciary power under state law, not an act by the beneficiaries.
e. If the decanting is made in resolution of an actual bona fide dispute, then this should strengthen the position of the beneficiaries to claim that no taxable disposition or transfer occurred for income or transfer tax purposes.

3. Income Tax Considerations
   a. Concern: The act of decanting could be treated as a deemed sale or exchange under Code §1001 leading to the recognition of gain or loss.
      i. Decanting from a grantor trust to grantor trust should not be an income tax event. Rev. Rul. 85-13
      ii. Decanting from a non-grantor trust to grantor trust should not be an income tax event. See Chief Counsel Advice 200923024
      iii. Decanting from a grantor trust to a non-grantor trust may possibly be an income tax event. See Madorin v. Commissioner, 84 T.C. 67 (1985); Treas. Reg. § 1.1001-2(c)(5), Ex. 5.
      iv. *Cottage Savings Assoc. v. Commissioner*, 499 U.S. 554 (1991) – compare legal entitlements before and after decanting to determine if a taxable exchange has occurred for income tax purposes.

4. Estate Tax Considerations
   a. Should not be a concern as long as the settlor does not control the decanting and the parties are not deemed to have made contributions to the resulting trust(s).

5. Gift Tax Considerations
   a. Concern: A gift may be deemed to be made to the extent the decanting shifts value from one beneficiary to the other.
   b. The act of decanting is the exercise of a fiduciary power under state law and, thus, the beneficiaries are not voluntarily making any transfers of value between them.
      i. What if the beneficiaries fail to object?
      ii. What if the beneficiaries do not have the legal authority to prevent the decanting?
   c. Settlements resulting from bona fide disputes/litigation should be deemed transfers for full and adequate consideration, and thus, not a gift.

6. GST Tax Considerations
   a. The Trust is currently non-exempt. Prior to the decanting, a generation-skipping transfer would have occurred only if Cersei did not survive to age 55 or a distribution was made to Cersei's descendants. By extending the Trust term for Cersei's lifetime, however, a generation-skipping transfer

will occur at Cersei's death if any assets remain in the trust. Thus, Tywin should consider making a late allocation of his GST exemption to the new trust after the decanting is completed.

b. What if the trust was GST exempt prior to the decanting? The concern is that the transfer of assets from one exempt trust to an entirely new trust may cause the assets to lose their exempt status.

   i. The IRS has held in numerous non-binding private letter rulings that, at a minimum, a change that would not affect the GST status of a grandfathered GST exempt trust would similarly not affect the exempt status of trusts that are exempt as a result of an allocation of GST exemption. See e.g., PLR 200839025.

   ii. Treas. Reg. § 26.2601-1(b)(4)(i)(A) – Safe Harbor Requirements to Preserve Exempt Status in a Decanting

      1. Either the terms of the trust authorize decanting without the consent of any beneficiary or court, or at the time the exempt trusts became irrevocable, state law authorized decanting without the consent of any beneficiary or court; and

      2. The terms of the second trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest for a period, measured from the date the first trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus, if necessary, a reasonable period of gestation.

      3. Postponing or suspending the vesting or absolute ownership of an interest for a term of years that will not extend 90 years is expressly permitted.