WR Marketplace

a Finseca Washington Report

The WR Marketplace is created exclusively for Finseca members by experts at Baker & Hostetler LLP and the Finseca staff. WR Marketplace #20-23 was written by Michael P. Vito, Counsel, and John F. DeStefano, Associate, Baker & Hostetler LLP.

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Topic: Trust Modifications: Innovative Techniques for Outdated Instruments

Market trend: New and emerging trends provide innovative solutions for adapting irrevocable trusts to changing circumstances.

Synopsis: Although the grantor of an irrevocable trust surrenders the right to revoke the trust and amend its terms, the restrictions are no longer as limiting as they once were. Alternatives to judicial modifications abound. From nonjudicial settlement agreements to new trends in decanting practices to innovations in modifications by consent, clients, trustees and beneficiaries have many potential avenues for modifying an irrevocable trust to accomplish their legacy planning goals.

Takeaways: If the provisions of an older irrevocable trust have become obsolete or no longer serve their intended purpose, there may be a viable method for modifying the trust instrument. Taking time to consider the available modification options in light of a client's current circumstances may prove worthwhile.

Prior Reports: 20-21; 17-22; 14-21; 12-2.

What can be changed?

There are many potential motivations for seeking to modify an irrevocable trust. Some of the most common include:

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- **Updating Trustee Provisions.** For any number of reasons, trustee succession and appointment provisions may no longer be appropriate to the current situation. In the past decade, several well-known financial institutions have eliminated their trust companies, and the trust instrument may list a successor trustee which is no longer in operation. Older trusts also typically contain provisions such as minimum capitalization requirements for institutional trustees which have the effect of prohibiting a family's own private trust company from serving – a novel legal development that would not have been contemplated at the time the trust was created. Allowing a beneficiary to remove and replace trustees or become a co-trustee at a given age are also common goals.

- **Updating Administrative Provisions and Fiduciary Powers; Removing Investment Restrictions.** Over time, a trust's "boilerplate" provisions may become outdated. For example, older trust instruments may not have anticipated the proliferation of private equity, social impact investing, benefit corporations ("B-corps"), or the complexity of modern financial instruments. Without express authority to invest in these types of securities, many trustees are unwilling to do so. A modification can be used to update the trustee's powers accordingly.

- **Retaining Assets in Trust.** Historically, it was more common to create trusts that paid funds to a beneficiary upon attaining certain age milestones (e.g., one-quarter at age 30, one-half at age 40, and the balance at age 50). However, assets distributed outright to the beneficiary can become exposed to creditors and will be includible in the beneficiary's gross estate for estate tax purposes. In some cases, it is simply not in the beneficiary's best interests to receive outright distributions according to a predetermined timeline. Here, a trust may be modified to eliminate staggered payments in favor of a longer-term discretionary trust.

- **Modernizing Distribution Standards.** Trusts that provide for only a health, education, maintenance and support distribution standard may not offer the creditor protection or flexibility of a trust that provides for fully discretionary distributions. Some older trusts may also cap annual distribution amounts per year which no longer reflect the modern cost of living. Depending on the circumstances, it may be permissible to update a trust's distribution standards.

- **Granting Powers of Appointment.** Upon the passing of a trust's primary beneficiary, the trust assets may divide automatically for the primary beneficiary's descendants in equal shares. If the descendants have disparate financial or family circumstances, an equal division may not be the optimal result. Through a modification, the primary beneficiary may be granted a limited power to appoint trust assets among descendants equally or unequally or in differing trust formats for additional flexibility.

- **Changing Grantor or Non-Grantor Trust Status.** Trusts that were originally drafted as grantor or non-grantor trusts may potentially be converted to the opposite status through a modification.

Modification methods

Judicial Petition. Historically, modifying an irrevocable trust required court approval. Then and now, petitioning a court to change the terms of an irrevocable trust typically involves a public filing, notice to all interested persons, and disclosure of the trust instrument and the

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proposed changes, which may reveal sensitive family information. Court involvement also involves a degree of uncertainty; whether a judge will agree to the changes is no guarantee. Although there are still occasions when court approval may be necessary or desirable, several alternatives exist which can accomplish the same goals.

Nonjudicial Settlement Agreement. Nonjudicial settlement agreements are an alternative to court involvement and are often used to resolve matters of trust administration. The Uniform Trust Code ("UTC") includes a nonjudicial settlement agreement provision allowing the trustee and trust beneficiaries to enter into a binding agreement to modify trust provisions with the same effect as a court order, as long as the agreement does not violate a material purpose of the trust and only includes terms and conditions that a court could approve.[i] The UTC provides a list of matters that may be addressed by a nonjudicial settlement agreement, including:[ii]

- Interpreting or construing the terms of a trust;
- Approving the report or accounting of a trustee;
- Granting a power to a trustee, or directing a trustee to refrain from exercising a power;
- Approving the resignation, appointment or compensation of a trustee;
- Transferring the trust's principal place of administration; and
- Determining a trustee's liability in connection with an action.

The UTC's list gravitates toward issues of trust administration, but the UTC comments clarify the list is non-exhaustive and nonjudicial settlement agreements may cover a great variety of matters.

Decanting. Decanting allows a trustee with discretionary distribution authority to move trust assets from one trust to another, often without court approval and possibly without providing notice to the beneficiaries. Over time, the notion of decanting that was initially sanctioned by a few courts has become more widely adopted by state legislatures. Most recently, jurisdictions are considering codifying the model Uniform Trust Decanting Act alongside their version of the Uniform Trust Code.

As decanting becomes ubiquitous, its mechanics continue to evolve in favor of additional flexibility. For example, a traditional decanting required the trustee of the original trust to actually distribute the trust's assets to a second trust, which often meant executing a new trust instrument, obtaining a federal tax identification number for the new trust, transferring and retitling assets, and filing a final income tax return for the original trust. Now, it can also be possible to "decant a trust into itself," essentially modifying an existing trust using decanting authority but without creating a second trust or moving assets. Delaware's decanting statute, for example, now provides that the second trust in a decanting "may be a separate trust or the first trust as modified."[iii] This innovative trend can help ease the cost and administrative burden normally associated with decanting.

While decanting is subject to various conditions (e.g. a mandatory income interest generally cannot be eliminated), some of these limitations have eroded as well. For example, a common principal of decanting is that new beneficiaries cannot be added to the second trust if they were not beneficiaries of the first trust (though the opposite was permitted, i.e., beneficiaries could be

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"cut out" of the second trust). At the same time, many decanting statutes allow a power of appointment to be added to the second trust which may then be exercised in favor of persons who are not beneficiaries of the original trust. Thus, in practical effect, a decanting potentially can be used to transfer trust assets to persons whom the grantor did not include as beneficiaries of the original trust. As another example, an original prerequisite to decanting was that the trustee possess unfettered discretionary authority to distribute principal (often phrased in terms such as "best interests" or as the trustee "deems wise"). More jurisdictions are allowing the trustee to decant where the trustee only has authority to distribute principal pursuant to an ascertainable standard, although the parameters for decanting under an ascertainable standard can be more restrictive.

Although these are only a few examples, they demonstrate a legal trend toward providing trustees with more latitude. Ultimately, decanting continues to become a more flexible method for modifying an irrevocable trust to accomplish various objectives, even those beyond what may have been contemplated when the trust was created.

Modification by Consent. Perhaps the most flexible means of modifying an irrevocable trust is a developing trend that permits modification by the consent of all interested persons. A relatively new Delaware statute is among those at the forefront.[iv] If the grantor, fiduciaries and all beneficiaries agree, this broad authority allows the parties to modify an irrevocable trust to include any currently lawful provision, even if such modification or provision violates a material purpose of the trust or would not have been permitted when the trust was created. Whether doing so triggers negative transfer tax consequences is a separate issue which must be considered, but the statute gives largely free reign.

The tradeoff for such flexibility is confidentiality. Full disclosure is a tenet of modification by consent, and a complete copy of the current trust instrument and the proposed changes should accompany the operative modification document. Consequently, this route may not be as ideal for sensitive family situations as a decanting (where the action is taken by the trustee and, depending on the circumstances, may not require notice to the beneficiaries). Where family dynamics and transfer tax implications are not an issue, using statutory authority to modify a trust with the consent of all interested persons may be a compelling option.

Fiduciary Restructuring. Many irrevocable trust modifications stem from a need or desire to alter the fiduciary structure. Creating a "directed trust" is a common motivation. With a directed trust, an advisor directs or instructs the trustee regarding trust investments, distributions or other matters while the trustee serves an administrative role and simply follows the directions provided by the advisor. This structure can offer flexibility, for example, where the trust holds closely-held business interests that an independent trustee may not be willing or able to manage. Instead, a "business advisor" may direct the trustee with respect to voting and operating the business. As long as the trustee follows the advisor's direction, the applicable statute shields the trustee from liability.

Ordinarily, adding directed trustee provisions to a trust instrument must be accomplished through a decanting or other modification. However, an emerging trend may provide a simpler method of achieving the same result. Here again, Delaware is among those forging a new path. A Delaware statute passed in 2019 and amended in 2020 allows the grantor to re-format the fiduciary roles if the grantor possesses a power under the trust instrument to replace trustees.[v] All of the provisions applicable to trustees under the trust instrument remain intact (e.g., trustee qualifications, resignation, standard of care, etc.), but the grantor can allocate various trustee

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powers, including the power to direct or prevent certain actions, exclusively to one or more fiduciaries.

This power may be used to create a traditional directed trust structure where the trustee acts at the direction of an advisor. More interestingly, the power may also be used to completely bifurcate fiduciary duties among separate trustees. Rather than being directed, each trustee has independent authority to act with respect to a delineated aspect of administration. In effect, the trustees are "excluded trustees" with respect to each other and do not share duties, powers or liability for any actions over which the trustee has exclusive authority. For example, the investment and distribution functions may be split such that an "Investment Trustee" has exclusive authority to manage the trust's assets, while a "Distribution Trustee" has exclusive authority to distribute income and principal to the beneficiaries. Other jurisdictions, such as Florida,[vi] allow the bifurcation of fiduciary duties among trustees, but generally speaking the provisions must be in the initial trust instrument or added later via a decanting or modification. Allowing a grantor to modify the fiduciary structure using a retained trustee appointment power is an innovation.

Merger. Merger is well-established common law doctrine which can have the result of modifying a trust in a limited way. This approach should be considered for simplicity or where other methods are unavailable or undesirable. Typically, a trust instrument or state law will allow a trustee to combine trusts for the same beneficiary, whether or not created by the same grantor, if the trusts have substantially identical dispositive provisions and there is no material change in the beneficial interests. In a case where multiple trusts have been created for the same beneficiary over time, but later trusts have more modern administrative provisions, the older trusts may be able to be merged into the newer trusts. There are a number of issues and restrictions to consider (e.g., the perpetuities period and generation-skipping transfer tax status of the trusts) but merging trusts can often be a more straightforward and efficient option to accomplish a modification where a full decanting or modification is not necessary or possible.

Accessing more favorable law

Not all states have yet decided to inject more flexibility into modifying irrevocable trusts. However, more frequently irrevocable trusts are intentionally moved from their original place of creation to a different jurisdiction that offers more robust trust laws to better serve the beneficiaries. Relocating a trust involves taking the necessary steps to change the trust's principal place of administration (situs) and/or governing law. Once accomplished, the trust modification methods permitted under the new jurisdiction will become be available. For additional information on trust situs, please see the previous WRMP "Zooming into a new age of trust situs."

Takeaways: If the provisions of an older irrevocable trust have become obsolete or no longer serve their intended purpose, there may be a viable method for modifying the trust instrument. Taking time to consider the available modification options in light of a client's current circumstances may prove worthwhile.

Notes

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[i] UTC § 111(c).
[ii] UTC § 111(d).
[iii] 12 Del. C. §3528.
[iv] *See* 12 Del. C. §3342. The statute was enacted in 2016, and amended in 2017, 2018 and 2020.
[v] *See* 12 Del. C. §3343.
[vi] *See* Fla. Stat. §736.0703(9).

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