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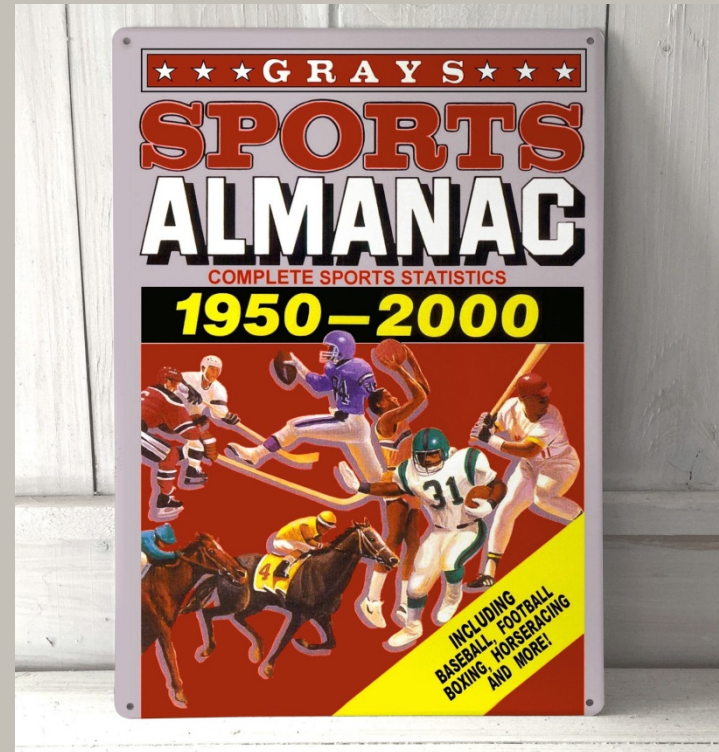


# Planning for Humans

*Irrevocable trust modification for  
the non-omniscient*

# MODIFYING IRREVOCABLE TRUSTS

*Have you either of these?*



# MODIFYING IRREVOCABLE TRUSTS

## *What do we not know?*

No matter how well advisors get to know a client, there are at least three things we will not know:

- 1) When a client will die
- 2) What the client will own at that point
- 3) What the laws will say then
  - A) “No man's life, liberty, or property are safe while the legislature is in session.”  
Mark Twain or Gideon J. Tucker

# MODIFYING IRREVOCABLE TRUSTS

*What changes might be desirable?*

Circumstances change; a good estate plan must change as well. Possible desired modifications:

- **Converting a trust with mandatory distributions into a discretionary trust.**
- **Adding powers of appointment** to get estate inclusion and basis adjustment at death of certain individuals.
- **Qualifying a trust under the Utah DAPT law.**
- **Providing for continuation of the trust** rather than outright distribution as the beneficiaries attain certain ages.
- Changing trustee succession provisions.

# MODIFYING IRREVOCABLE TRUSTS

*What changes might be desirable?*

Circumstances change; a good estate plan must change as well. Possible desired modifications (cont.):

- Adding or removing beneficiaries or changing beneficiary rights.
  - But maybe not adding charity if seeking income tax deduction!  
More on this later.
- Adding a trust protector to increase flexibility.
- Modifying trustee or grantor powers to change grantor trust status.
- Changing notice or accounting provisions to create a quiet trust.

# MODIFYING IRREVOCABLE TRUSTS

*What changes might be desirable?*

What types of trusts may need a makeover?

- Credit Shelter/Bypass Trusts (from an AB Trust)
- ILITs
- Dynasty Trusts
- NINGs, DINGs, WINGs, etc.

# MODIFYING IRREVOCABLE TRUSTS

*What changes might be desirable?*

## AB Trust Example:

- John and Jane had an old AB trust created in the 1990s.
- John passes away with \$1MM in assets, which goes into an irrevocable credit shelter trust.
- Surviving spouses live, on average, 10 years
- Without any changes, appreciation or depreciation deductions occurring during this “overlife” will result in income tax for John’s and Jane’s heirs.



# MODIFYING IRREVOCABLE TRUSTS

*What changes might be desirable?*

## AB Trust Example (cont.):

- If appreciation averages 5%, John's \$1MM will grow to \$1,628,900 over 10 years.
- Resulting tax at Utah rates: \$181,122.
- Solution?
  - Modification to implement various techniques to cause estate inclusion in Jane's estate.
  - No retitling necessary, credit shelter trust can still provide creditor and remarriage protection.
- How would your client feel about you if you could redirect this 181k from Uncle Sam to the family?

# MODIFYING IRREVOCABLE TRUSTS

*What changes might be desirable?*

## ILIT Example:

- Policy is a permanent policy with significant cash value.
- H established the trust and only the kids are beneficiaries. H would like to access the cash value or possibly sell appreciating business interests to it without losing all access.
- Modification to add W as beneficiary can provide access to assets now

# MODIFYING IRREVOCABLE TRUSTS

*What changes might be desirable?*

## Dynasty Trust Example:

- Parents established trust for kids that provides for mandatory income payments now and payout of principal in portions as kids attain certain ages (such as 25, 30, 35).
- Parents foresee possibility of divorce or creditor trouble in kids' lives.
- Trust modification can give trustee discretion to distribute or withhold and can provide for continuing trust management and even make kids own trustees.

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Options for Revising Trust Provisions:

- What does “irrevocable” mean?
  - Not revocable alone by the person who formed it— not necessarily unchangeable in any way.
- The Utah Trust Code (the “UTC”) Sections 410-416 offer a variety of methods for changing irrevocable trusts:
  - Nonjudicial modification (no court involvement).
  - Judicial modification (approved by court order).
- Not statutory but possibly available: **Decanting**

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

Nonjudicial modification (without a court):

- Say the settlor is around and wants to change the trust.
- This often happens with ILITs or dynasty trusts.

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Nonjudicial modification (without a court):

- UTC 411(1): if the settlor (grantor) and all the beneficiaries agree, the trust can be modified by consent and without a court order
- This is true even if the modification is inconsistent with a material purpose of the trust—the reason doesn't matter.
- There are important “representation of beneficial interest” considerations here—stay tuned

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Nonjudicial modification (without a court):

- Nonjudicial modification has appeal, but perhaps some risk
  - Estate inclusion risk?
  - “Representation of beneficial interest” considerations here—stay tuned

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Nonjudicial modification (without a court):

- Estate inclusion risk?
- ACTEC provided comments on the Uniform Trust Code and recommended requiring court approval
  - Powell v. Commissioner, 148 T.C. No. 18
  - If settlor has power to modify or revoke, “either alone or in conjunction with any person,” estate inclusion can result under IRC 2036 and 2038



# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Nonjudicial modification (without a court):

- UTC 411(1): what if the settlor cannot participate because of incapacity?
  - No modification without a court order.
  - An agent under a power of attorney (if the power of attorney or terms of the trust expressly grant this power to the agent) or a court-appointed guardian/conservator can represent the settlor in termination of a trust.

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- What if the settlor is not around and we want to modify the trust?
- This often happens with “credit shelter” trusts or other trusts that become irrevocable after the death of the settlor.

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- If the settlor doesn't participate, you have a few options for modification:
  - UTC 411(2) conditions:
    - All beneficiaries consent
    - Court finds modification is not inconsistent with a material purpose of the trust
  - Stay tuned for important “representation of beneficial interest” considerations

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- What if not all beneficiaries consent?
- UTC 411(5) conditions. Court finds:
  - Modification not inconsistent with a material purpose of the trust
  - If all benes had consented, trust could be modified
  - Interests of non-consenting bene will be adequately protected

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- What if not all beneficiaries consent? (cont.)
- UTC 412 conditions:
  - A court can modify administrative or dispositive terms of trust if, because of circumstances not anticipated by settlor, modification will further purposes of trust.
  - Settlor's probable intention must be followed, if practicable.

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- UTC 412 conditions:
  - Court may modify if existing terms would be impracticable or wasteful or impair trust admin
- Circumstances need not have changed—it is enough if settlor was unaware of them at time trust was established.

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- Examples:
  - Trust requires retention of real property that becomes inefficient to administer and detracts from overall performance of trust assets.
    - The court may authorize modification of trust to allow for real property to be sold and proceeds invested.

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- Examples:
  - Trust provides income for life to W, remainder to C. Evidence indicates Settlor's intent was to provide for W's needs and expected income to be sufficient.
    - W develops health condition resulting in major medical expenses exceeding income.
    - Court can modify to allow trustee to use principal for W's needs.



# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- Examples:
  - Trust provides for outright distribution or, alternatively, permits the beneficiary to act as his/her own trustee at a given age.
    - B is receiving needs-based gov't benefits that would be lost, or the trust estate would be lost, under trust terms.
  - Court can modify to create supplemental needs trust with separate trustee.

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- From a leading treatise:
- Through modification, the court “is permitting the trustee to do not what the settlor intended to permit ... but what it thinks the settlor would have permitted if he had known of or anticipated the circumstances that have happened. Even though the settlor has expressly forbidden what the court permits to be done, the theory is that he would not have forbidden it, but on the contrary would have authorized it if he had known of or anticipated the circumstances.” (emphasis added)

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- UTC 416 conditions:
  - The court may modify the terms of a trust in order to achieve the settlor's tax objectives. The court may provide that the modification has retroactive effect.
  - The modification may, but need not, relate to a change in tax law

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- UTC 416 examples:
  - AB trusts were intended to maximize the use of the couple's federal estate tax exemption.
    - Behold: portability!
  - AB trusts were intended to minimize overall taxation (estate tax rate was 55%)
    - 40% rate is closer to cap gain rate; w/o estate tax savings, net effect is negative

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- UTC 416 examples:
  - ILIT may have been created to hold insurance outside of estate to minimize taxes
  - May not be needed with larger exemption amounts,

# MODIFYING IRREVOCABLE TRUSTS

## *How Change We This?*

### Modification with a court:

- UTC 416 examples:
  - May need to authorize division of trusts for:
  - QTIP purposes
  - GST purposes (zero inclusion and reverse QTIP)
  - QDOT purposes

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

Benefits of getting a court order:

- Finality as to the beneficiaries (under certain circumstances)
- Finality as to the IRS (under certain circumstances)

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

Finality as to the beneficiaries:

- Interests of beneficiaries need to be represented
  - In nonjudicial modification, for consent
  - In judicial modification, for protection of interests



# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

Finality as to the beneficiaries:

- What beneficiaries have protectable interests?
  - UTC 103: “Beneficiary” means a person that:
    - (A) has a present or future beneficial interest in a trust, vested or contingent; or
    - (B) in a capacity other than that of trustee, holds a power of appointment over trust property. (emphasis added)

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

Finality as to the beneficiaries:

- How do we protect future and contingent beneficiaries?
  - UTC 303: if there is no conflict of interest:
    - A conservator can bind protected person
    - Guardian can bind ward
    - Agent can bind principal (with specific authority)
    - Personal rep can bind estate
    - Parent can bind minor or unborn child

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

Finality as to the beneficiaries:

- Simple, right?
  - Remember the caveat—if there is no conflict of interest
  - When might parent, for example, have conflict of interest in representing child?

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

### Finality as to the IRS:

- U.S. v. Bosch, SCOTUS, 1967
- If IRS was not a party to the proceeding and decision rendered by any court other than highest state court, IRS need not follow order for tax purposes

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

### Finality as to the IRS:

- Rev. Rul. 73-142
  - A lower court state decision will be binding on IRS, even though not a party to the proceedings, if issued “before the time of the event giving rise to the tax.”

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## *Tax and other pitfalls to avoid*

### Finality as to the IRS:

- Bosch v. Rev. Rul. 73-142 Example 1:
  - Rapp v. Comm'r, 9<sup>th</sup> Cir., 1998
    - Business attorney drafted estate plan
    - Bad QTIP
    - Reformation proceeding after H's death granted, guardian appointed to represent grandchildren

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

### Finality as to the IRS:

- Bosch v. Rev. Rul. 73-142 Example 1:
  - Rapp v. Comm'r, 9<sup>th</sup> Cir., 1998
    - IRS ignored court order for tax purposes
    - The tax event had passed (H's death) and thus Rev. Rul. 73-142 safe harbor did not apply
    - Court order still bound benes, so they had QTIP without tax benefits

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## *Tax and other pitfalls to avoid*

### Finality as to the IRS:

- Bosch v. Rev. Rul. 73-142 Example 2:
  - PLR 200543037
    - H created two trusts for W and later died
    - W petitioned court for order assigning estate tax liability to one of the trusts (GST non-exempt trust), then later died
    - W's death was the tax event, and since court order happened before that, IRS was bound



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## *Tax and other pitfalls to avoid*

### Finality as to the IRS:

- CCA 201651013
  - A court order modified a trust to add charity as a beneficiary
  - Trust contributed all assets to charity and terminated
  - Charitable deduction denied!

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

### Finality as to the IRS:

- CCA 201651013
  - IRC 642(c) says distributions to charity must be made “pursuant to governing instrument” and IRS decided the unmodified trust was the governing instrument
  - IRS: “But you still get the non-tax benefits of the donation!”

# MODIFYING IRREVOCABLE TRUSTS

## *Tax and other pitfalls to avoid*

### Finality as to the IRS:

- Court modification does not require consent of all beneficiaries—should you get it anyway?
  - TAM 9419007
  - PLR 9451049
  - PLR 8535020
  - Beneficiary consent may = taxable gift. Be thoughtful!

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## *Tax and other pitfalls to avoid*

### Decanting

- What is it?
  - [https://www.actec.org/assets/1/6/Mezzullo\\_Comments\\_04\\_02\\_12.pdf](https://www.actec.org/assets/1/6/Mezzullo_Comments_04_02_12.pdf)
- Does it work in Utah?
  - *Ferri v. Powell-Ferri*, 476 Mass. 651 (2017)

# Questions?

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