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State Law Allows Modification of Irrevocable Trusts

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Background

Modification of a trust under the laws of the various US states has traditionally been possible only through judicial action, often requiring the consent of all beneficiaries, through a court-approved equitable deviation or in certain circumstances by consent of the settlor and all beneficiaries. The common law of some states may allow the trustee to distribute trust property to another trust, even one created by that trustee, but generally only when that trustee's power to invade principal is unlimited.

For longstanding trusts, trustees and beneficiaries may find that changes in family circumstances or investment opportunities cause trust provisions to become restrictive or inflexible. For example, trustees or beneficiaries might wish to modify an irrevocable trust to allow for the appointment of an investment director who would be exclusively responsible for trust investments and to relieve the trustee from liability for those decisions. They might also wish to improve the trust's governance structure or change dispositive provisions to meet the needs of a new generation of beneficiaries.

Changes in state law, either through the adoption of the Uniform Trust Code or the enactment of a decanting statute, have injected flexibility into rules governing the modification of an irrevocable trust.⁽¹⁾

Uniform Trust Code

Twenty states have enacted, wholly or partly, the Uniform Trust Code, which modernizes traditional trust law by expanding a beneficiary's and trustee's ability to amend an irrevocable trust. The code is a model drafted by the National Conference of Commissioners on Uniform State Laws as a recommended statute for states to enact to promote uniformity among state trust laws.⁽²⁾ The code provides several means to modify an irrevocable trust. Three of these methods have potentially broad application:

- modification with the consent of the settlor and all beneficiaries. No standard or trust purpose need be shown if these parties consent. Such a modification can be made with or without court approval;
- modification without the consent of the settlor, a particularly useful option for older trusts. A non-charitable irrevocable trust may be modified upon consent of all beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust. A court may approve the modification even if the beneficiaries do not consent, as long as the modification is not inconsistent with any material purpose of the trust and the interests of any dissenting beneficiary are adequately protected. Although a trustee has standing to object, a modification may be imposed over a trustee's objection; and
- modification upon a demonstration of the trust purpose, a frustration of that purpose and a modification that provides a remedy. A court may modify a trust's administrative or dispositive terms, or terminate the trust, if, because of changed or unanticipated circumstances, it will further the trust's purposes.

State Decanting Statutes

Decanting statutes allow a trustee with discretionary distribution authority over a trust to modify the terms and conditions upon which trust property

is held for its beneficiaries by transferring all trust property to a new trust, in many cases even when the language of the old trust provides only for distributions to or for the benefit of the trust beneficiaries. Typically, neither settlor nor beneficiary consent is required for a trustee to exercise its authority under a decanting statute. New York was the first state to pass such a statute, followed by Alaska, Delaware, Tennessee, and most recently, South Dakota and Florida. Other states, reportedly including Ohio and Pennsylvania, are considering enacting similar statutes.

Decanting statutes typically impose limits on who may be a beneficiary of the new trust and when the trustee's distribution authority is sufficiently discretionary to enable that trustee to take advantage of the statute. Delaware's statute requires that the new trust have as its beneficiaries only persons who are proper objects of the exercise of the trustee's power. That is, beneficiaries of the new trust must be only those persons who were beneficiaries of the old trust and for whose benefit the trustee of the old trust had discretionary authority to make distributions. Tennessee's statute is similar to Delaware's. New York's statute requires the new trust to have as its beneficiaries the proper objects of the exercise of the power. Florida's statute requires the new trust to be for the current benefit of those persons to whom the trustee of the old trust may make distributions, and generally be for the benefit of the beneficiaries of the old trust. It also imposes an extended notice period, which may be waived by the beneficiaries.

The New York and Florida statutes are applicable only if the trustee's discretion to make distributions is absolute. Alaska's statute, which previously required the trustee's discretion to be absolute, was revised in 2006 to permit decanting even where the trustee's discretionary authority to distribute is limited by a standard. Neither Delaware's nor Tennessee's statute requires that a trustee's discretion to make distributions be absolute.

In many cases, the decanting statutes of these states do not provide the flexibility needed to permit the new trust to have as a current beneficiary a contingent beneficiary of the old trust, and do not permit changes to the contingent beneficiaries (eg, to remove one of them). Where changed family circumstances necessitate changes to a trust's dispositive provisions, the family and its advisers may wish to look to the South Dakota statute, which is broader in this respect.

South Dakota

South Dakota's decanting statute requires only that a trustee have discretionary authority to make distributions, without requiring that authority to be unfettered or absolute. The beneficiaries of the new trust must be either (i) proper objects of the current exercise of the distribution power under the old trust, or (ii) beneficiaries to, or for whom, a distribution of income or principal may have been made in the future under the old trust at the time or upon the happening of a specified event.

The second category provides that the new trust's beneficiaries, even primary beneficiaries, need not be proper objects of the current exercise of the discretionary power. They can instead be persons who are contingent beneficiaries of the old trust. The language of the statute permits the new trust to have different beneficial interests from the old trust. It allows formerly contingent beneficiaries to become current beneficiaries and share equally - or pursuant to a different allocation - with those who previously were the only current beneficiaries.

To make use of the statute, the trustee must first determine that the appointment is necessary or desirable after considering the purposes of the trust from which property is to be distributed, the terms and conditions of the new trust and the consequences of the distribution. Because South Dakota's statute is very new, its language regarding the trust's purposes has not been interpreted by the courts. The statute uses the term 'purposes' without a modifier, such as 'material purposes' or 'primary purposes'.

Courts should defer to the trustee's judgement as to whether the distribution is necessary or desirable, as the statute's language does not invite judicial review. It states that trustees may act provided they take the trust's purposes into account, indicating that the trustee has discretion. In other areas of trust law, when decisions are left to a trustee's discretion, courts do not readily substitute their judgement for that of a trustee in the exercise of that discretion, but intervene only when there has been an abuse of that discretion.

Change of Situs and Governing Law

For families and their trustees who wish to modify an irrevocable trust, it

may be necessary first to change the situs of the existing trust and its governing law in order to take advantage of a state with Uniform Trust Code provisions or a decanting statute. Such a change may be expressly authorized in the trust document or may be permitted under the current applicable law. Where not expressly authorized, a broad power to appoint a successor trustee in another state, thereby changing the place of administration, may result in a change of applicable law where not contrary to the intent of the trust creator. It may be necessary to seek judicial approval for a change in situs and governing law. Regardless, a trustee is well advised to seek out competent trust counsel before undertaking such a change.

Tax Consequences

Before taking advantage of trust provisions or applicable law that allows a trustee to modify the terms of the trust or to distribute all trust property to a new trust, a prudent trustee should first consider whether such an action will result in adverse income or transfer tax consequences. For example, distributing all assets to a new trust may cause the existing trust to lose its exemption from generation-skipping transfer tax, trigger recognition of gain for income tax purposes or result in a deemed gift for gift tax purposes. It may even cause a domestic trust to be considered foreign for tax purposes. The Uniform Trust Code and decanting statutes may provide opportunities for beneficiaries and trustees to depart from outdated or inflexible trust provisions, but such action must be taken cautiously.⁽³⁾

For further information on this topic please contact Jennie Cherry or Rashad Wareh at Kozusko Harris Vetter Wareh LLP by telephone (+1 212 980 0010) or by fax (+1 212 751 0084) or by email (jcherry@kozlaw.com or rwareh@kozlaw.com).

Endnotes

⁽¹⁾ For further discussion of the modernization of state trust law please see "State Law Allows Settlers to Tailor Trust Investment Objectives" and "State Law Allows Settlers to Modify Trustee Duty to Inform and Report".

(2) The full text of the Uniform Trust Code and a list of enacting states can be found at www.utcproject.org.

(3) For further discussions on this topic please see Rashad Wareh's article on trust remodelling which appears in the August 2007 issue of *Trusts & Estates Magazine*, available at www.kozlaw.com/think/writings/Trust_Remodeling.pdf.

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