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Modification & Termination of Irrevocable Trusts

Presented By:

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What We'll Cover

- Reasons for Modification or Termination
- Utilizing Existing Trust Provisions
- Informal Options
- State Court Modification or Termination
- Trust Decanting
- Planning opportunities will be considered throughout

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REASONS FOR MODIFICATION OR TERMINATION

I. Non-tax reasons

A. Changed circumstances

1. Trustmaker's changed goals
 - a. Desire to change beneficiaries?
 - b. Desire to change terms
 - c. Trust no longer wanted?

2. Beneficiary Concerns

- a. Receiving government benefits
- b. Drug or alcohol addiction
- b. Spendthrift

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REASONS FOR MODIFICATION OR TERMINATION

II. Tax reasons

A. Estate tax considerations

- 1. Client no longer subject to estate tax

B. Income tax considerations (Bypass Trusts)

- 1. Client's family may be subject to income tax

III. Other Considerations?

A. Asset Protection . . . (this should not be overlooked!)

- 1. E.g., \$12,800 of protection for cash value insurance in CA

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UTILIZING EXISTING TRUST PROVISIONS

A. Distribution Provisions

- 1. Mandatory or discretionary withdrawal rights?
2. E.g., at specified ages or years after trust formation

B. Lifetime Powers of Appointment? (See DE Tax Trap discussion below)

- 1. Who can power be exercised in favor of?

C. Special Trustee Powers?

D. Trust Protector Powers?

- 1. Does the trust protector have the authority to accomplish objective?
2. Can the trust protector exercise that authority in fiduciary/non-fiduciary capacity?

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UTILIZING EXISTING TRUST PROVISIONS

E. Use "Swap Powers" to substitute high basis assets if step-up is desired

F. Testamentary Powers of Appointment

- 1. Who can power be exercised in favor of?
2. Intentionally invoking the Delaware Tax Trap
a. DE Tax Tap involves the exercise of a power of appointment (lifetime or testamentary) to create a new POA that has the potential to extend the rule against perpetuities
b. Under IRC Section 2041(a)(3), exercise of such power at death causes estate tax inclusion for the original power holder
c. Under Sec. 2514(d), exercise of such power during life also causes estate tax inclusion for the original power holder
i. I.e., trust assets receive a step-up in basis for income tax purposes and the original power holder is the transferor for GSTT purposes

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UTILIZING EXISTING TRUST PROVISIONS

F. Testamentary Powers of Appointment cont.

2. Intentionally invoking the Delaware Tax Trap

a. Factors:

- i. Broad limited lifetime or testamentary POA
- ii. Low basis assets over which desire a step-up in basis and/or
- iii. Non-exempt trust assets that will be subject to GSTT
- iv. No "Delaware Tax Trap Savings Clause" in the trust

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UTILIZING EXISTING TRUST PROVISIONS

Example 1: intentionally invoking the Delaware Tax Trap

- Irrevocable trust grants Alice a testamentary limited POA in favor of her descendants
- Alice exercises the power by granting her son Ben a *presently exercisable* GPOA
- Under the common law of nearly all states, the date of creation of the presently exercisable GPOA is the date of exercise of the original limited power
- Conversely, under common law, the date of creation of a limited power is the original trust date, which would not invoke the DE Tax Trap
- AZ law appears to give the original power holder the option of choosing the date of exercise when granting a *LPOA*, thereby also invoking the DE Tax Trap*

* See Raatz, *Delaware Tax Trap* Opens Door to Higher Basis for Trust Assets* (avail. online)

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UTILIZING EXISTING TRUST PROVISIONS

Example 2: Intentionally invoking the Delaware Tax Trap in a USRAP state (e.g. CA Prob. Code Sec. 21212)

USRAP Section 2-902(c) provides: "A nonvested property interest or a power of appointment arising from a transfer of property to a previously funded trust or any other existing property arrangement is created when the nonvested property interest or power of appointment in the original contribution was created."

- I.e., Provides for estate tax inclusion because a transfer to a previously funded trust via POA is determined as of creation of the original POA grant.
- Purpose seems to be to eliminate need for trustee to keep track of different RAPs for assets contributed to a trust via POAs
- For Example, Irrevocable third-party Trust 1 grants Alice a testamentary limited POA in favor of her descendants
- Alice A contributes \$10,000 to a new Trust 2, in which she has a LPOA. Alice then appoints the property of Trust 1 to Trust 2.
- T2 assets are included in Alice's estate under Sec. 2041(a)(3) or 2514(d)

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INFORMAL OPTIONS

A. Consent Agreement under Probate Code Sections 16463-5

- 1. P.C. Sec. 16463 (a): Except as provided in subdivisions (b) and (c), a beneficiary may not hold the trustee liable for an act or omission of the trustee as a breach of trust if the beneficiary consented to the act or omission before or at the time of the act or omission.
- 2. P.C. Sec. 16464 (a): Except as provided in subdivision (b), a beneficiary may be precluded from holding the trustee liable for a breach of trust by the beneficiary's release or contract effective to discharge the trustee's liability to the beneficiary for that breach.
- 3. P.C. 16465 (a): Except as provided in subdivision (b), if the trustee, in breach of trust, enters into a transaction that the beneficiary may at his or her option reject or affirm, and the beneficiary affirms the transaction, the beneficiary shall not thereafter reject it and hold the trustee liable for any loss occurring after the trustee entered into the transaction.

Coupled with "Notice of Proposed Action" under Probate Code Section 16500?

INFORMAL OPTIONS

B. "Notice of Proposed Action" under Probate Code Section 16500:

Subject to subdivision (d) of Section 16501, a trustee may give a notice of proposed action regarding a matter governed by Chapter 2 (commencing with Section 16200) or Chapter 3 (commencing with Section 16320) as provided in this chapter. For the purpose of this chapter, a proposed action includes a course of action or a decision not to take action. This chapter does not preclude an application or assertion of any other rights or remedies available to an interested party as otherwise provided in this part regarding an action to be taken or not to be taken by the trustee.

INFORMAL OPTIONS

Probate Code Sec. 16501 (d): Notwithstanding any other provision of this chapter, the trustee may not use a notice of proposed action in any of the following actions:

- (1) Allowance of the trustee's compensation; (2) Allowance of compensation of the attorney for the trustee; (3) Settlement of accounts; (4) Preliminary and final distributions and discharge; (5) Sale of property of the trust to the trustee or to the attorney for the trustee; (6) Exchange of property of the trust for property of the trustee or for property of the attorney for the trustee; (7) Grant of an option to purchase property of the trust to the trustee or to the attorney for the trustee; (8) Allowance, payment, or compromise of a claim of the trustee, or the attorney for the trustee, against the trust; (9) Compromise or settlement of a claim, action, or proceeding by the trust against the trustee or against the attorney for the trust; (10) Extension, renewal, or modification of the terms of a debt or other obligation of the trustee, or the attorney for the trustee, owing to or in favor of the trust.

JUDICIAL
MODIFICATION/TERMINATION

A. Probate Code Section 15403 (all beneficiaries consent)

(a) Except as provided in subdivision (b), if all beneficiaries of an irrevocable trust consent, they may compel modification or termination of the trust upon petition to the court.

(b) If the continuance of the trust is necessary to carry out a material purpose of the trust, the trust cannot be modified or terminated unless the court, in its discretion, determines that the reason for doing so under the circumstances outweighs the interest in accomplishing a material purpose of the trust. Under this section the court does not have discretion to permit termination of a trust that is subject to a valid restraint on transfer of the beneficiary's interest . . .

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JUDICIAL
MODIFICATION/TERMINATION

B. Probate Code Section 15409 (changed circumstances)

(a) On petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust. In this case, if necessary to carry out the purposes of the trust, the court may order the trustee to do acts that are not authorized or are forbidden by the trust instrument.

(b) The court shall consider a trust provision restraining transfer of the beneficiary's interest as a factor in making its decision whether to modify or terminate the trust, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer.

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JUDICIAL
MODIFICATION/TERMINATION

C. Probate Code 15404 termination (settlor and beneficiaries consent)

(a) If the settlor and all beneficiaries of a trust consent, they may compel the modification or termination of the trust.

(b) If any beneficiary does not consent to the modification or termination of the trust, upon petition to the court, the other beneficiaries, with the consent of the settlor, may compel a modification or a partial termination of the trust if the interests of the beneficiaries who do not consent are not substantially impaired.

(c) If the trust provides for the disposition of principal to a class of persons described only as heirs or next of kin of the settlor, or using other words that describe the class of all persons who would take under the rules of intestacy, the court may limit the class of beneficiaries whose consent is needed to compel the modification or termination of the trust to the beneficiaries who are reasonably likely to take under the circumstances.

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TRUST DECANTING

A. What is decanting?

1. decant (di'kaent) (vb) to pour (a liquid, such as wine) from one container to another, especially without disturbing any sediment*

B. How does it work?

1. Trustee transfers (pours) property from old trust to new trust with more favorable terms
2. Not an unlimited power; limited by state decanting statute

C. Examples of States with Decanting Statutes: AK, AZ, CO, DE, FL, IL, IN, KY, MI, MN, MO, NV, NH, NY, NC, OH, SC, SD, TN, TX, VA, WI and WY

* Collins English Dictionary – Complete and Unabridged, 12th Edition 2014 © HarperCollins Publishers

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TRUST DECANTING

D. Decanting Issues (non-exhaustive list). May new trust:*

1. Change beneficiaries' distribution rights or distribution standard
2. Add/subtract beneficiaries
3. Accelerate remainder beneficiaries' interests
4. Add/subtract powers of appointment
5. Add special needs trust provisions

E. Other issues:

1. Tax: marital and charitable deduction savings clause issues; gift and GSTT issues; non-grantor to grantor trust (and vice versa)
2. Rule Against Perpetuity

* See Bart, *Summaries of State Decanting Statutes* (avail. online)

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TRUST DECANTING

E. Nevada's Decanting statute (effective 10/15/15) - New trust may:

1. Eliminate mandatory withdrawal rights except as to marital trusts, charitable trusts and GRATs
2. Change beneficiaries, subject to restrictions
 - a. "The second trust to which a trustee appoints property of the first trust may only have as beneficiaries one or more of the beneficiaries of the original trust . . ." § 163.556(2)
3. Add/change powers of appointment
4. Non-interested trustee may change distribution standard; interested trustee cannot

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