Notre Dame Tax & Estate Planning Institute

UNDOING WHAT WE'VE DONE
CHANGING AND UNWINDING IRREVOCABLE TRUSTS

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Diana focuses her practice on estate and tax planning for high-net-worth individuals and families, including intra-generational wealth transfer strategies and business succession planning. Her practice includes planning for United States and non-United States citizens and residents. Diana also assists clients with litigated probate, trust, and guardianship matters, and represents clients before the Internal Revenue Service in matters involving fiduciary income tax and estate, gift, and generation-skipping transfer tax controversies. She represents corporate and individual fiduciaries in connection with the administration of estates and personal and charitable trusts. Diana also assists clients in preparing prenuptial and postnuptial agreements. She has participated in numerous projects involving governmental submissions in the estate, gift, and GST tax areas and serves as an expert witness in cases involving her practice areas.

Diana is a frequent lecturer and author and has spoken on a variety of topics before the American College of Trust and Estate Counsel, the Real Property, Trust and Estate Section of the American Bar Association, the Real Property, Probate and Trust Law Section of the Florida Bar, as well as various other professional organizations.

Prior to attending college and law school, Diana was a professional ballet dancer. She received her training on a full scholarship at the Joffrey Ballet School in New York, and was awarded an apprenticeship with the Company. She instead accepted an offer to join the Chicago Ballet, where she was quickly given the opportunity to perform soloist and principal roles.

Diana received her LL.M. in Taxation from New York University School of Law (1993), her J.D. from Yale Law School (1986), and her B.A., *summa cum laude*, from Yale University (1982), where she was elected to *Phi Beta Kappa.*

Table of Contents

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The advent of the current version of the generation-skipping transfer tax is at least partially responsible for the increased popularity of long-duration irrevocable trusts.[1] Many states have modified their statutes to accommodate this trend either by eliminating the rule against perpetuities or by substantially increasing the period during which a party may hold property in trust.[2] An increased desire to achieve asset protection[3] through the use of trusts may also be responsible for the increased use of long-duration irrevocable trusts.

Yet drafting a long-term irrevocable trust is a challenging undertaking for the draftsperson. During the continuation of the trust, the law, the circumstances of the trust beneficiaries, or both may change in a way that was not foreseen or considered when drafted. These changes might render the trust's terms more adverse, inefficient, or disadvantageous to the beneficiaries than other terms would be. In addition, with increased estate, gift and generation-skipping transfer tax shelters, many taxpayers may find that a long-duration trust is tax adverse because the assets of the trust estate do not receive a basis adjustment at the grantor's death, yet the grantor's estate may not be subject to transfer tax.

The law accommodates the need to make changes to an irrevocable trust in a number of ways. *Restatement (Third) of Property* adds a judicial modification provision making a trust or other donative disposition of property subject to judicial modification to the extent that the trust or other disposition does not terminate on or before the expiration of the perpetuity period.[4] The Uniform Trust Code and the Uniform Trust Decanting Act both contain provisions allowing changes to be made to an irrevocable trust after the fact.

If long-duration trusts are here to stay, the need to change trusts after creation will become necessary. Accordingly, to analyze the consequences of making changes to an irrevocable trust, one must understand what is permitted under applicable law, and the tax consequences of making or enabling changes.[5]

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[1] *See* Robert H. Sitkoff & Max. M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 410 (2005).

[2] *See id*. 110-12.

[3] Asset protection includes the ability to shield assets from the claims of creditors. *See* Harold Rosen & Gideon Rothschild, 810-3rd Tax Mgmt. (BNA) Estates, Gifts, and Trusts; Todd A. Flubacher & Randolph K. Herndon, Jr., *Delaware Asset Protection Trusts and Creditors' Rights*, EST. PLAN., Sept. 2010, at 19, 20.

[4] *See id*. Concerned about the potential harm of an irrevocable trust with extreme duration, the drafting committee that extended Florida's rule against perpetuities to 360 years added a provision to Florida's version of the Uniform Trust Code that requires a trust taking advantage of the longer term to permit judicial modification of the trust in the interest of the beneficiaries. *See* FLA. STAT. ANN. § 736.04115(3) (West 2010) (providing that its provisions permitting judicial modification of a trust in the best interests of the beneficiaries will not apply to a trust created after December 31, 20(X), only if "all beneficial interests in the trust must vest or terminate within the period prescribed by the rule against perpetuities in [section] 689. 225(2), notwithstanding [section] 689. 225(2)(0" (in other words, the common law rule) and finding that the trust prohibits judicial modification).

[5] Changes to irrevocable trusts can also have income tax consequences, but those effects are beyond the scope of this paper.

I. Defining the Transferred Property

A. For Estate Tax Purposes

Article I, section 9 of the United States Constitution provides, "[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."[6] A direct tax on wealth thus would seem to be unconstitutional. The estate tax is said to be, however, a tax on the transfer of property, not on its receipt.[7]

Estate tax value is based upon the aggregate assets includible in the decedent's gross estate at the moment of death.

> [T]he estate tax is laid only on that which passes at death, not what was owned before death or what the legatee receives after death. Since the tax is laid upon the decedent's estate as a whole, and not upon the property which is received by the various legatees, the valuation of decedent's assets, *at least for purposes of computing his gross taxable estate under section 2031*, can usually be made without reference to the destination of those assets.[8]

The moment of death means that potentially very brief moment before the interests of the subsequent beneficiaries vest when both restrictions on the decedent's ability to transfer property and value added by the decedent's presence end.

In *United States v. Land*,[9] the U.S. Court of Appeals for the Fifth Circuit described the moment of death as follows:

> Brief as is the instant of death, the court must pinpoint its valuation at this instant—the moment of truth, when the ownership of the decedent ends and the ownership of the successors begins. It is a fallacy, therefore, to argue value before–or–after death on the notion that valuation must be determined by the value either of the interest that ceases or of the interest that begins. Instead, the valuation is determined by *the interest that passes,* and the value of the interest before or after death is pertinent only as it serves to indicate the value *at* death. In the usual case death brings no change in the value of property. It is only in the few cases where death alters value, as well as ownership, that it is necessary to determine whether the value at the time of death reflects the change caused by death, for example, loss of services of a valuable partner to a small business.[10]

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[6] U.S. CONST. art. 1, § 9.

[7] *See* Ithaca Trust Co. v. United States, 279 U.S. 151, 155 (1929) ("The tax is on the act of the testator not on the receipt of property. . . ."); Ahmanson Found. v. United States, 674 F. 2d 761, 768 (9th Cir. 1981).

[8] Estate of Chenoweth v. Comm' r, 88 T.C. 1577, 1582 (1987) (citations omitted); *see also Ahmanson Found.*, 674 F. 2d at 768 (distinguishing pre-distribution transformations and changes in value brought about by the testator's death from changes in value resulting from the assets of the gross estate coming to rest in different beneficiaries' hands under the decedent's estate plan).

[9] 303 F. 2d 170 (5th Cir. 1962).

[10] *Id.* at 172.

The property law principles governing a particular interest will impact its transfer at the time of decedent's death. In *Pierre v. Commissioner,*[11] the Tax Court described the relationship between state law determinations of property interests and federal taxation as follows:

> A fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights. It is well established that the Internal Revenue Code creates "no property rights but merely attaches consequences, federally defined, to rights created under state law."[12]

In *Morgan v. Commissioner,*[13] the Court disregarded the state law classification of a power of appointment as "special" because federal law classified the rights associated with that state law power of appointment (that is, the power to appoint to anyone, including the holder's estate and creditors) as a general power of appointment. Adhering to a pattern common in federal estate and gift tax cases, state law created the interest, which the Court respected and which the government taxed pursuant to the federal estate and gift tax provisions.[14] In short, the Court ignored the label, not the property interest created, and determined whether the interest fell within the federal statute. In *Knight v. Commissioner,*[15] the Tax Court followed the precedent set by *Morgan*: *"*State law determines the nature of property rights, and Federal law determines the appropriate tax treatment of those rights."[16]

Accordingly, the Tax Court in *Pierre* concluded that under New York law the donor had no property interest in the underlying assets of the LLC involved in the taxable gifts made by the taxpayer; thus, the interest that the donor transferred was, for federal gift tax purposes, an interest in the LLC, not the underlying assets of the LLC.[17]

An interest in property would appear to include any interest, even one that is contingent. Section 2033 [18] applies to property in which the decedent had an interest and provides that "[t]he value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."[19] Treasury Regulation § 20.2033-1 clarifies the rule:

> The gross estate of a decedent who was a citizen or resident of the United States at the time of his death includes under section 2033 the value of all property, whether real or personal, tangible or intangible, and wherever situated, beneficially owned by the decedent at the time of his death.[20]

Yet, the definition of gross estate must be interpreted by section 2001, which imposes a tax "on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States."[21] Accordingly, two elements are necessary to impose an estate tax: an interest in property and the decedent's ability to transfer

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[11] 133 T.C. 24 (2009), *supplemented by* Pierre v. Comm'r, 99 T.C. Memo. 2010-106, 99 T.C.M. (CCH) 1436.
[12] *See id.* at 29 (quoting United States v. Nat'l Bank of Commerce, 472 U.S. 713, 722 (1985) (internal quotation marks omitted)).
[13] 309 U.S. 78 (1940).
[14] *See id.* at 80-82.
[15] 115 T.C. 506 (2000).
[16] *Id.* at 513 (citing Nat'l Bank of Commerce, 472 U.S. at 722).
[17] Pierre*,* 133 T.C. at 30-31, 36.
[18] All references to a "section" or "§" of the Code or the Treasury Regulations refer to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.
[19] I.R.C. § 2033.
[20] Treas. Reg. § 20.2033-1(a).
[21] I.R.C. § 2001(a).

the interest at death. If the interest disappears at death—for example, if it is a contingent remainder interest with an unsatisfied condition—no estate tax is imposed.[22] For example, a trust providing income to *A* for life, remainder to *B* if *B* survives *A* constitutes a contingent remainder interest contingent on survival. If *B* predeceases *A*, no portion of the trust is included in *B*'s estate. *B*'s interest has evaporated. Similarly, in a state that has enacted UPC section 2-707, a trust providing income to *A* for life, remainder to *B* converts B's remainder interest to a contingent remainder conditional upon surviving *A*.[23] Thus, if *B* dies before *A*, no portion of the trust estate is included in *B*'s gross estate under section 2033.[24] However, in a state that has not enacted the abatement provision applicable to trusts, *B*'s interest would be a vested remainder interest and as such would be subject to transfer by *B* both during life and at death. *B* therefore has an interest subject to estate tax even if *B* does not survive *A*.

While the foregoing appears fair in so far as *B* has a property interest susceptible of transfer, the vested remainder subject to divestment raises more concerns. Suppose a trust provides income to *A* for life, remainder to *B*, but if *B* does not survive *A*, then to *C*. Under the common law, the foregoing language would confer on *B* a vested remainder subject to divestment.[25] This distinction may not matter if the inquiry is estate tax inclusion. One will know at *B*'s death whether *B* survived *A*; if *B* did not survive, *B*'s interest will have lapsed upon *B*'s death. But if the condition did not operate simultaneously with *B*'s death, estate tax inclusion and the attendant valuation issues would arise.

Treating a remainder interest in a revocable trust as a vested remainder subject to divestment might surprise some. In Revenue Ruling 67-370, the Internal Revenue Service (Service) considered an *inter vivos* trust, controlled by New York law, under which the decedent or his estate was to receive the principal upon the death of the settlor.[26] The ruling notes that "[t]he settlor had reserved the right to modify, alter, or revoke the trust during her lifetime" and that "[s]ubsequent to the decedent's death, the settlor modified the trust and extinguished the estate's defeasible remainder interest."[27] The ruling holds:

> In providing that the value of the gross estate shall include the value of "all" property to the extent of the interest therein of the decedent at the time of his death, section 2033 is not affected by formal legal distinctions of nomenclature under state law. Therefore, it is not relevant to the application of section 2033 that a particular interest in property which survives the decedent's death may be either defeasible or indefeasible.
>
> Any determination of what would be the fair market value of a particular remainder interest like that under consideration herein would be affected by its possible curtailment or complete divestment at some point after decedent's death, in accordance with the general rules for the valuation of property which are set forth in section 20.2031-1(b) of the Estate Tax Regulations. The mere presence of these possibilities does not warrant the assignment of a merely nominal value to such a defeasible interest in any case where there is still a reasonable probability that the estate will actually

[22] *See generally* Mitchell M. Gans, Bridget J. Crawford & Jonathan G. Blattmachr, *The Estate Tax Fundamentals of Celebrity and Control*, 118 YALE L.J. POCKET PART 50 (2008); Mitchell M. Gans, Bridget J. Crawford & Jonathan G. Blattmachr, *Postmortem Rights of Publicity: The Federal Estate Tax Consequences of New State-Law Property Rights*, 117 YALE L.J. POCKET PART 203 (2008).
[23] *See* UNIF. PROBATE CODE § 2-707(b) (amended 2008), 8 pt. 1 U.L.A. 149-50 (Supp. 2011).
[24] *See id.*; I.R.C. § 2033.
[25] *See, e.g.*, Crowley v. Engelke, 68 N.E. 2d 241, 273 (Ill. 1946).
[26] *See* Rev. Rul. 67-370, 1967-2 C.B. 324.
[27] *Id*. at 324.

> acquire possession of at least some substantial portion of the property in question.[28]

However, depending on applicable state law, Revenue Ruling 67-370 might not apply to a more traditional revocable trust created for the primary benefit of its settlor during the settlor's lifetime. In *Darian v. Weymouth*,[29] the Florida District Court of Appeals determined that a devise, granted to the decedent's surviving spouse under the decedent's revocable trust and not conditioned upon the spouse's survival, nevertheless failed to vest prior to the decedent's death. The decedent created the revocable trust before Florida's antilapse statute.[30] The spouse's adopted son killed the settlor and spouse, and the probate court deemed their deaths to be simultaneous.[31] The court cited the Florida Supreme Court case *Travis v. Ashton*, which held that if an element of futurity is annexed to the substance of the gift, rather than enjoyment of it, vesting is suspended and the gift is contingent.[32] Accordingly, in Florida, when the beneficiaries of a revocable trust do not come into possession of an interest until the settlor's death, the interest is contingent upon the settlor not exercising his power to revoke.[33]

In Revenue Ruling 76-472, the Service considered how to value vested remainder interests held by one of a class composed of a life tenant's issue.[34] The ruling states that, in general, future interests in property that a decedent owns at death are taxed just like possessory interests.[35] Thus, the value of a vested remainder interest is includible in the value of a remainderman's gross estate under section 2033, even though the remainderman dies before obtaining possession of the property:[36]

> In making the valuation, the actuarial value of the decedent's remainder interest, ascertained by the formula set forth in section 20.2031-10(d) of the regulations, should be the starting point. Consideration should then be given to all known facts and circumstances that might tend to decrease such value, with due regard for (1) the certainty that a woman who has reached the age of 53 years will not bear children is far greater than that attends most other human affairs and (2) the unlikelihood that a woman of that age will adopt a child.[37]

One wonders what advances in assisted reproductive technology might do to these kinds of computations and whether data even exists from which to analyze the probabilities.[38]

B. <u>For Gift Tax Purposes</u>

Treasury Regulation section 25.2511-2(a) provides the following:

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[28] *Id*. at 325.
[29] 76 So. 3d 15 (Fla. Dist. Ct. App. 2011).
[30] *See id*. at 17.
[31] *See id*. at 17-18.
[32] *See id*. at 17 (citing Travis v. Ashton, 23 So. 2d 725, 727 (Fla. 1945)).
[33] *See id*. (citing Fla. Nat'l Bank of Palm Beach Cnty. v. Genova, 460 So. 2d 895, 897 (Fla. 1984)).
[34] *See* Rev. Rul. 76-472, 1976-2 C.B. 264.
[35] *See id*.
[36] *See id*.; I.R.C. § 2033.
[37] Rev. Rul. 76-472, 1976-2 C.B. 264.
[38] *See In re* Martin B., 841 N.Y.S. 2d 207, 207-08 (Sur. Ct. 2007) (permitting children conceived posthumously by decedent's widow to be included in the definition of *issue* and *descendants* for purposes of trusts created by decedent's father when decedent, knowing of his fatal illness, gave widow control of his semen for such purposes).

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon [the] ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.[39]

The language of the regulation appears to leave open the opportunity to construe the gift tax as applicable to the donor's loss of value by treating that reduction as a transfer, even if no specific donee receives that value. Nevertheless, in Technical Advice Memorandum 9449001, the Service openly acknowledged that material differences exist in the administration of the gift tax and the estate tax, notwithstanding that the two taxes are generally construed in *pari materia*.[40] The estate tax is imposed on the "transfer of the taxable estate" of the decedent.[41] Under section 2051, taxable estate means the value determined by the deductions from the value of the gross estate.[42] Gross estate, in turn, means the value at the time of death of all the decedent's property.[43] In contrast, the law imposes gift tax on the property passing from the donor to each donee, and the value of that property is the basis for measuring the tax.[44]

With regard to both the estate tax and the gift tax, the transferor seemingly must begin with a property interest susceptible of transfer. However, gift tax law acknowledges that the specific identity of the donees may be undefined and that a transfer may be implied based upon a loss in value to the property interests that the donor held.[45] Treasury Regulation section 25.2511-1(e) states the following:

> If a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred. . . . [I]f the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift. Thus if a donor, aged 65 years, transfers a life estate in property to A, aged 25 years, with remainder to A's issue, or in default of issue, with reversion to the donor, the gift tax will normally be applicable to the entire value of the property.[46]

Subsection (f) applies to the transfer of a limited interest in property:

> If a donor is the owner of only a limited interest in property, and transfers his entire interest, the interest is in every case to be valued by the rules set forth in §§ 25.2512-1 through 25.2512-7. If the interest is a remainder or reversion or other future interest, it is to be valued on the basis of actuarial

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[39] Treas. Reg. § 25. 2511-2(a).
[40] *See* Tech. Adv. Mem. 9449001 (Mar. 11, 1994). Under section 6110(k)(3), neither a private letter ruling nor a technical advice memorandum may be cited or used as precedent. *See* I.R.C. § 6110(k)(3). However, under Treasury Regulation section 1.6662-4(d)(3), both may be considered authority for purposes of avoiding certain tax penalties. *See* Treas. Reg. § 1.6662-4(d)(3).
[41] I.R.C. § 2001(a).
[42] *See* I.R.C. § 2051.
[43] *See* I.R.C. § 2031(a).
[44] *See* Rushton v. Comm'r, 60 T.C. 272, 276 (1973), *aff'd*, 498 F. 2d 88 (5th Cir. 1974); Rev. Rul. 93-12, 1993-1 C.B. 202.
[45] See Treas. Reg. § 25.2511-2
[46] *Id.* § 25.2511-1(e).

> principles set forth in § 25.2512-5, or if it is not susceptible of valuation in that manner, in accordance with the principles set forth in § 25.2512-1.[47]

Treasury Regulation § 25.2512-1 establishes, for gift tax purposes, the general valuation principle that the value of property transferred by gift "is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."[48] If a transfer is for consideration and the consideration is insufficient, the value of the gift equals the difference between the value of the property and the consideration in money or money's worth that the donor received in exchange for the property.[49] However, a transfer "made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth."[50]

A transfer of a trust interest also may be subject to section 2702. Treasury Regulation § 25.2702-2(a)(2) provides that "[a] transfer in trust includes a transfer to a new or existing trust and an assignment of an interest in an existing trust," but does not include "[t]he exercise, release or lapse of a power of appointment over trust property that is not a transfer under chapter 12."[51] This means that the exercise would not diminish a property interest held in the trust by the powerholder and that the power is not a general power of appointment within the meaning of section 2514.

Thus, a transferable property interest appears to be unnecessary to create a taxable gift. The relinquishment of a present or future interest in trust may be the subject of a gratuitous transfer, and the identity of the specific transferee is not needed. One must simply determine the value of the donor's interest before and after the transfer. To the extent the interest is one in trust—unless the donor's retained interest is a qualified retained interest within the meaning of section 2702—the law will likely assign the interest a zero value, transferring the entire interest held.[52] The law could potentially measure the transfer by either the loss of value to the donor or the tax consequences of holding that interest.

In *Smith v. Shaughnessy,*[53] the Supreme Court held that "the language of the gift tax statute, 'property . . . real or personal, tangible or intangible,' is broad enough to include property, however conceptual or contingent."[54] Accordingly, the Court held that a transfer of property granting a life estate, a remainder interest, and a reversion constituted a taxable gift to both the life estate and the remainder interest, even though the transfer was subject to a possible reversion if the donor survived the life tenant.[55] The dissent sought to frame the question in terms of whether the reversion negated the gift's completion until the donor relinquishes the interest,[56] but the majority was satisfied to rely on the appropriate actuarial computations.[57]

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[47] *Id.* § 25.2511-1(f)
[48] *Id.* § 25.2512-1.
[49] *See id.* § 25.2512-8.
[50] *Id.*
[51] *Id.* § 25.2702-2(a)(2).
[52] *See* I.R.C. § 2702.
[53] 318 U.S. 176 (1942)
[54] *Id.* at 180.
[55] *See id.* at 181.
[56] *See id*. at 183 (Roberts, J., dissenting).
[57] *See id*. at 178 (majority opinion).

In *Commissioner v. Wemyss*,[58] the taxpayer entered into a prenuptial agreement whereby he agreed to transfer a block of stock to his fiancée to compensate her for the loss of an income interest in a trust upon remarriage. The Supreme Court found the transfer to be a gift "not made in the ordinary course of business."[59] The Court reinforced the lack of a requirement of donative intent, stating that "Congress chose not to require an ascertainment of what too often is an elusive state of mind."[60] The Court found that the exception for business transactions reinforced the breadth of the gift tax's application:

> To reinforce the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech, the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding "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 any donative intent)."[61]

Even though a contingent interest may not be transferable, the inquiry may not end there. Section 2511(a) provides that the gift tax applies to gifts made indirectly.[62] The Treasury Regulations clarify that any transaction in which an interest in property is gratuitously passed to or conferred upon another may constitute a taxable gift, regardless of the device employed.[63] Courts have extended this rule to instances in which the taxpayer fails to enforce legal rights. For example, in *Lang v. Commissioner*,[64] a mother made a taxable gift to her son by failing to collect on loans made to the son and permitting the statute of limitations to expire. Similarly, relinquishing rights in a corporation—such as a right to dividends, a right to convert preferred stock to nonvoting preferred stock entitled to a cumulative dividend, and a right of purchase—may constitute a taxable gift.[65] The foregoing authorities, however, do not squarely cover the situation of a contingent interest in a trust. Because a contingent interest in trust is not typically transferable, the taxable transfer of a contingent interest is seemingly possible only if the contingent interest is given up. If one relinquishes a contingent interest other than by a qualified disclaimer within the meaning of section 2518, the degree to which that relinquishment enhances the value of property interests held by others may constitute a taxable gift.[66]

In *Jewett v. Commissioner*,[67] the Court held that the disclaimer of a contingent remainder interest, made decades after the original transfer in trust, was subject to gift tax. In reaching its holding, the Court determined that the "expansive reading of the statutory language in *Smith v. Shaughnessy* unquestionably encompasse[d] an indirect transfer, effected by means of a disclaimer, of a contingent future interest in a trust."[68] The Court found that Congress had specifically indicated that the term *transfer*, at least as used in the statutory provisions defining the gift tax, is "used in the broadest and most comprehensive sense."[69] The Court's holding conflicted with the decision of the U.S. Court of Appeals for the Eighth Circuit in *Keinath v. Commissioner*,[70] which applied the prevailing common law rule that the holder of a vested

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[58] 324 U.S. 303 (1945).
[59] *Id*. at 307.
[60] *Id*. at 306.
[61] *Id*.
[62] *See* I.R.C. § 2511(a).
[63] *See* Treas. Reg. § 25. 2511-1(1).
[64] 613 F. 2d 770 (9th Cir. 1980).
[65] *See* Snyder v. Comm'r, 93 T.C. 529 (1989); Tech. Adv. Memo 873007; PLR 9117035 (Apr. 26, 1991).
[66] *See* I.R.C. § 2518.
[67] 455 U.S. 305 (1982).
[68] *Id*. at 310 (citing Smith v. Shaughnessy, 318 U.S. 176 (1943)).
[69] *Id*. at 309 (internal quotation marks omitted).
[70] 480 F. 2d 57 (8th Cir. 1973), *overruled* by Irvine v. United States, 936 F. 2d 343 (8th Cir. 1991).

remainder interest subject to divestiture has a reasonable time after the death of the life beneficiary to renounce or disclaim the remainder without tax consequences.[71] In *Jewett*, the Court noted that *Keinath* "emphasized that the holder of the remainder interest did not obtain a right to beneficial ownership and control of the property until the death of the life beneficiary,"[72] and rejected *Keinath*'s reasoning, finding that the disclaimer was not timely and that the property disclaimed was therefore subject to gift tax.[73] The dissent sought to distinguish a disclaimer from a voluntary transfer of property on the basis that a transfer to the disclaimant is incomplete because acceptance has not occurred.[74] In addition, a transferor chooses the recipients of the transfer, but a disclaimant can make no such selection.[75] The dissent's reasoning is inconsistent, however, with the notion that one can make a gift of any interest in property, even if the interest has not yet become possessory.

In Revenue Ruling 81-264, the Service confirmed that a taxable gift can occur by permitting legal rights to expire.[76] The ruling considered the consequences of permitting the statute of limitations to run on the recovery of a loan to a family member and concluded that the lender made a gift to the debtor, who had some financial resources repay the loan.[77] The facts of the ruling are as follows:

> *D* loaned $500,000 to *D*'s child, *A*, and received from *A* a promissory note payable on demand, bearing interest at the market rate. At the time of the transaction, *D* and *A* intended that the note be enforceable. The state statute of limitations on recovery of a demand loan and accrued interest is three years and begins to run on the date of the making of the loan. *D* did not make demand on the note and the state statute of limitations on recovery of the loan and accrued interest ran . . . When the statute ran, *A* had some financial resources.[78]

Revenue Ruling 81-264 states that if the loan is made as part of a prearranged plan under which the lender "intends to forgive or not collect on the note, the note will not be considered valuable consideration and the promisee will have made a gift at the time of the loan to the full extent of the loan."[79] If there is no "prearranged plan, but the promisee later forgives the debt, the promisee will have made a gift at the time of the forgiveness."[80] The amount of the gift will be "the principal amount forgiven and the interest accrued to the date of the forgiveness."[81] General Counsel Memorandum 38,584 states that Revenue Ruling 81-264 based its conclusion on *Estate of Lang v. Commissioner*,[82] which held that the lapse of the statute of limitations on the collection of certain loans made by Mrs. Lang to her son transformed the loans into gifts because it transferred control of the debt to the debtor at the end of the statutory period.[83] Thereafter, the debtor, not the creditor, decides whether and under what terms to repay loaned funds. Affirming the Tax Court's analysis, the U.S. Court of Appeals for the Ninth Circuit cited *Smith v. Shaughnessy* for the

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[71] *See id*. at 64.
[72] *Jewett*, 455 U.S. at 309 n.6.
[73] *See id*. at 318.
[74] *See id*. at 323 (White, J., dissenting).
[75] *See id*.
[76] *See* Rev. Rul. 81-264, 1981-2 C.B. 185.
[77] *See id*.
[78] *Id*.
[79] *Id*. (citing Rev. Rul. 77-299, 1977-2 C.B. 343).
[80] *Id*.
[81] *Id*. (citing Republic Petroleum Corp. v. U.S., 397 F. Stipp. 900 (E.D. La. 1975), re*v'd on other grounds*, 613 F. 2d 518 (5th cir. 1980); Treas. Reg. § 25. 2511-1).
[82] 64 T.C. 404 (1975), *aff'd in part, rev'd in part*, 613 F. 2d 770 (9th Cir. 1980).
[83] *See* Gen. Coun. Mem. 38,584 (Dec. 10, 1980) (citing Rev. Rul. 81-264, 1981-2 C.B. 185; Estate of Lang, 64 T.C. at 404).

proposition that the essence of a taxable gift is the abandonment of control over the property.[84] "That control is transferred by a statutory mechanism rather than an overt donative gesture is not significant."[85] The General Counsel Memorandum acknowledged, however, some circumstances may allow the lender to show that the statute of limitations lapsed in the ordinary course of business based upon the prospects of full recovery.[86]

Similarly, an income beneficiary's failure to exercise the power to make unproductive property productive may constitute a gift to the trust's remainder beneficiaries because this failure reduces the value of the retained income interest and increases the value of the trust corpus.[87]

In *Harris v. Commissioner*,[88] the Court acknowledged that the transfer of property between spouses could qualify as being in the ordinary course of business rather than as the voluntary settlement of marital rights based upon a promise or agreement. Without more, the Court would not have recognized such a voluntary settlement as full and adequate consideration:

> The Treasury Regulations recognize as tax free "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 any donative intent)." This transaction is not "in the ordinary course of business" in any conventional sense. Few transactions between husband and wife ever would be; and those under the aegis of a divorce court are not. But if two partners on dissolution of the firm entered into a transaction of this character or if chancery did it for them, there would seem to be no doubt that the unscrambling of the business interests would satisfy the spirit of the Regulations. No reason is apparent why husband and wife should be under a heavier handicap absent a statute which brings all marital property settlements under the gift tax.[89]

In *Harris*, the property given to the husband greatly exceeded the value of the property received by the wife.[90] By holding that the arrangement was in the ordinary course of business, the Court found that no gift tax was due notwithstanding the substantial inequality of the property transferred between the spouses (the Court decided this case long before enactment of the unlimited marital deduction).[91]

However, the *Harris* holding might have been dependent on court approval of the property division. In Revenue Ruling 68-379, the Service seems to depart from *Harris*.[92] In this ruling, "[a] husband and wife entered into an agreement incident to a legal separation. Pursuant to the agreement, the husband transferred property to the wife in full settlement of her property and support rights."[93] The ruling concluded that the transfer of property under these circumstances constitutes "a taxable gift to the extent the value of the

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[84] *See id*. at 773 (citing Smith v. Shaughnessy; 318 U.S. 176, 181 (1943)).
[85] *Id*.
[86] *See* Gen. Coun. Mem. 38,584 (Dec. 10, 1980).
[87] *See* PLR 9045047 (Aug. 15, 1990); PLR 9035029 (Aug. 31, 1990); PLR 9035022 (Aug. 31, 1990) (relying on the reasoning of *Dickman v. Comm'r,* 465 U.S. 330 (1984)).
[88] 340 U.S. 106 (1950).
[89] *Id*. at 112.
[90] *See id*. at 109.
[91] *See id*. at 112; *see also* Rev. Rul. 68-379, 1968-2 C.B. 414 ("[S]ince support rights are distinguishable from inheritance rights, a surrender of support rights is not a surrender of 'other marital rights' as that phrase is used in the regulations. A release of support rights constitutes a consideration in money or money's worth.").
[92] *See* Rev. Rul. 68-379, 1968-2 C.B. 414.
[93] *Id*. at 415.

property transferred [exceeds] the value of any support rights surrendered."[94] Although superseded by section 2516,[95] the ruling casts some doubt on the extent to which *Harris* supports an ordinary course of business exception in the context of transfers of property interests among family members absent a court approved settlement of a dispute concerning the parties' property rights.[96]

Revenue Ruling 79-327 considers the exercise of a power of appointment over a testamentary trust that gives an individual a lifetime income interest in the trust property with the power to appoint all or part of the trust property during lifetime to one or more children.[97] The ruling concludes that the exercise of the special power of appointment results in a gift, for purposes of section 2511, of the income interest in the underlying relinquished property.[98]

More troubling perhaps is the Service's continued adherence to the view that the relinquishment of a discretionary interest in a trust constitutes a taxable gift. In PLR 200243026, the settlor created an irrevocable trust for the benefit of the settlor's spouse, lineal descendants, and the spouses of those descendants.[99] The trustees had authority to distribute any amounts of net income among the beneficiaries as the disinterested trustee, in his sole discretion, deemed "necessary or appropriate for [the beneficiaries'] care, support, maintenance, education, advancement in life and comfortable living."[100] The settlor's spouse also appears to have had a discretionary interest in trust principal.[101] The spouse was "granted a lifetime power to appoint the principal of the [t]rust to any one or more of a group consisting of [the] settlor's lineal descendants and their spouses."[102] The settlor's spouse also had a testamentary power of appointment among the settlor's lineal descendants.[103] The spouse proposed to exercise his *inter vivos* power of appointment in part to appoint a trust for the benefit of his grandchildren.[104] The trust was otherwise exempt from the GST tax.[105] The Service ruled that although spouse's rights to receive income and principal distributions from the trust were subject to the sole discretion of the disinterested trustee, the relinquishment of those interests would be, under section 2511(a), a taxable gift, the value of which is a question of fact.[106] In addition, because the spouse will have made a taxable gift of his income and principal interests in the trust, he becomes the transferor of the taxable gift's value for purposes of chapter 13.[107] The spouse, therefore, is deemed to have made direct skip transfers to the trusts for grandchildren.[108]

PLR 200243026 cites to Revenue Ruling 75-550 for "the correct method of computing the value of a[n] . . . interest in a trust . . . subject to the discretionary power of the trustee to invade corpus for the benefit of others."[109] Revenue Ruling 75-550 concerns, for purposes of the credit for tax on prior transfers under section 2013, the computation of a decedent's interest in a residuary trust that is subject to the

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[94] *Id.*
[95] *See* I.R.C. § 2516.
[96] *See also* Rev. Rul. 79-363, 1979-2 C.B. 345 (stating that a transfer for benefit of an adult child constitutes a taxable gift unless spouse relinquished support rights of equal value to obtain the benefit).
[97] *See* Rev. Rul. 79-327, 1979-2 C.B. 342.
[98] *See id*. at 343.
[99] *See* PLR 200243026 (July 24, 2002).
[100] *Id*.
[101] *See id.*
[102] *Id*.
[103] *See id.*
[104] *See id*.
[105] *See id*.
[106] *See id*.
[107] *See id*.
[108] *See id*.
[109] *Id*. (citing Rev. Rul. 75-550, 1975-2 C.B. 357).

trustee's discretionary power to invade the corpus for the benefit of others.[110] The second decedent had an income interest in the trust.[111] The Service established that the trust anticipated corpus invasions for the children in the amount of $100,000 annually.[112] Accordingly, the Service computed the value of the life estate by taking the anticipated attrition of the corpus into account.[113] Thus, when the valuation problem is establishing the fair market value of the discretionary interest, the anticipated pattern of distribution is probative.[114] In such a case, limiting language, including language requiring the trustee to take other resources into account, might help to depress the interest's value, although such language may otherwise inhibit flexible administration of the trust and may prohibit decanting to effectuate a reformation.[115]

In PLR 201122007, the Service again ruled that the taxpayer made a taxable gift of her interest in the portion of the trust principal distributed to the remainder beneficiaries of a trust in which she had a discretionary interest.[116] The trust provided the following:

> [N]et income . . . shall be accumulated and added to the principal and shall not be distributed to any beneficiary except the ultimate beneficiaries of the principal and corpus of the trust at the termination of the trust, unless the trustee shall, in his absolute discretion, determine that the income thereof or some portion thereof should be distributed.[117]

The trust also authorized the trustee to distribute principal for "health, support or maintenance."[118] The taxpayer submitted an affidavit

> affirming that . . . her income and resources [were] sufficient to maintain her current standard of living for the remainder of her lifetime and any foreseeable emergencies; [that] her financial condition prevent[ed] her from receiving any income or principal from the trust pursuant to the terms of the trust; and [that] she . . . received no distributions from the trust . . . and [did] not anticipate any in the future.[119]

The co-trustee submitted an affidavit stating that, under the trust's terms, distributions may only be made to the taxpayer in the case of emergency.[120] The Service ruled favorably that the advancement of principal to the remainder beneficiaries did not cause a loss of GST exempt status.[121] However, the amount of the taxpayer's taxable gift that resulted from the relinquishment of her discretionary interest remained a question of fact on which the Service refused to rule.[122] On the bright side, the Service seemed to accept

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[110] *See* Rev. Rul. 75-550, 1975-2 C.B. 357.
[111] *See id*.
[112] *See id*.
[113] *See id*. at 358-59.
[114] *See id*.
[115] *See id*. at 358; FLA. STAT. ANN. § 736.04117 (West 2010) (requiring a trustee to have absolute discretion to invade a trust's principal in order to have the authority to decant).
[116] *See* PLR 201122007 (Jun. 3, 2011).
[117] *Id*. at 1.
[118] *Id*. at 2.
[119] *Id*.
[120] *See id*.
[121] *See id*. at 3.
[122] *See id*.

from the affidavits that the distributions to the taxpayer would be limited to income (apparently not corpus) and only for emergencies and that the value of the taxpayer's interest may be nominal.[123]

Given the foregoing analysis, a beneficial interest in a trust at death—even one that has not yet matured or is subject to divestment—is clearly a state law interest in property that may be subject to estate tax. Similarly, a voluntary transfer of a beneficial interest in a trust, either by surrendering the interest or exercising a power that extinguishes or reduces the interest, is subject to gift tax, even if the interest may have nominal value. The burden of demonstrating the possibly nominal value falls on the taxpayer. The failure to assert legal rights that results in a reduction or elimination of a property right also can create a taxable gift.

II. Rescission, Reformation, Modification, and Termination

A. What is Permitted?

1. Background[124]

The concept of modification, reformation, and termination of trusts by the beneficiaries is not unique to American law. English law permitted beneficiaries to terminate a trust at any time upon the consent of all beneficiaries, provided all beneficiaries were adult and *sui juries*.[125] By the 1950s, Parliament enacted the Variation of Trusts Act of 1958, which expressly permitted courts to modify or terminate trusts.[126] Parliament enacted this legislation to allow beneficiaries to avoid adverse tax consequences resulting from the terms of existing irrevocable trusts.[127] English law apparently treated the trust estate as belonging to the beneficiaries, particularly after the settlor's death.[128] This view repudiated the settlor's continuing control over the disposition of the assets held in trust.[129]

2. Claflin Doctrine

In contrast, the traditional rule in the United States disallows trust modification or termination prior to the time required by its governing instrument merely upon the beneficiaries' application. *In Claflin v. Clallin*,[130] the court held termination or modification of an irrevocable trust to be impermissible if it would be contrary to a material purpose of the settlor. The *Claflin* standard requires that beneficiaries not do violence to the settlor's intent. Accordingly, respect for the settlor's intent prevails unless that intent ran contrary to some rule of law or public policy.[131] The *Claflin* court declined to terminate a trust prior to its stated age termination date.[132] The court opined:

> The existing situation is one the testator manifestly had in mind, and made provision for. The strict execution of the trust has not become impossible; the restriction upon plaintiff's possession and control is, we think, one that the testator had a right to make; other provisions for the

[123] *See id*. at 4.
[124] This portion of the article based in part on the analysis set forth in JESSE DUKEMINIER, ROBERT H. SITKOFF &JAMES LINDOREN, WILLS, TRUSTS AND ESTATES 641(8th ed. 2009).
[125] *See* Saunders v. Vautier, (1841) 49 Eng. Rep. 282 (P.C.) 282 (appeal taken from S.C.).
[126] *See* Variation of Trusts Act, 1958, 6 & 7 Eliz. 2, c. 53, § 1 (Eng.).
[127] *See* DUKEMINIER, ET AL., *supra* note 141.
[128] *See id*.
[129] *See id*.
[130] 20 N.E. 454 (Mass. 1889).
[131] *See id*. at 456.
[132] *See id*.

> plaintiff are contained in the will, apparently sufficient for his support; and we see no good reason why the intention of the testator should not be carried out.[133]

The court stated that "[i]t cannot be said that [the] restrictions on the [beneficiary's] possession and control of the property [were] altogether useless, for there is not the same danger that [the beneficiary would] spend the property while it [was] in the hands of the trustees . . ."[134]

3. Claflin and Terminating a Trust

The *Claflin* doctrine continues to have significant impact not only on legislation dealing with modification, reformation and, termination of trusts, but also in court decisions dealing with requests for these actions. In *In re Trust Under Last Will & Testament of Weitzel*,[135] a mother created a trust for her daughter for the daughter's lifetime, remainder to the mother's two grandsons. The trust required the corporate trustee to pay income to the daughter or her guardian or apply the income for her benefit.[136] The trustee also had discretion to pay principal for the daughter's proper care, support, and maintenance.[137] The trust contained a spendthrift clause prohibiting the beneficiary from selling, assigning, transferring, or encumbering her inter-est.[138] The daughter and the two grandsons filed a petition to terminate the trust, alleging that financial problems of the daughter and her husband caused the formation of the trust and that because those concerns had been resolved, the trust had no continuing purpose.[139] The Iowa statute provided that the court may terminate an irrevocable trust upon the consent of all the beneficiaries if continuance of the trust on the same or different terms is unnecessary to carry out a material purpose.[140] The court cited *Restatement (Third) of Trusts* for the proposition that because a trust agreement might contain a spendthrift clause as a matter of routine, a spendthrift clause alone is insufficient to create or establish, or create a presumption of, a material purpose that would prevent a trust's termination.[141] The court instead focused on a provision expressing a wish that certain property not be sold, as well as on the fact that the decedent executed the will many years after the resolution of the beneficiary's financial problems and still provided for a trust.[142] The court quoted an observation from a prior Iowa case:

> [T]rusts are usually created for the purpose of withholding from the beneficiaries or other interested parties the control and disposition of the principal of the fund for reasons which appear sufficient to the trustor, and they are not usually regarded with satisfaction by the persons who are deprived of the possession of the estate. This, however, furnishes no ground for disregarding the conditions on which the bounty is to be bestowed, nor for refusing to carry out the expressed design of the party creating the trust.[143]

Accordingly, the court denied the petition for termination.

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[133] *Id*.
[134] *Id*.
[135] No. 09-0447, 2009 WL 4842807 (Iowa Ct. App. Dec. 17, 2009).
[136] *See id*. at *1.
[137] *See id*.
[138] *See id*.
[139] *See id*. at *2.
[140] *See id*. at *4.
[141] *See id*. at *5 (citing RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. e (2003)).
[142] *See id*.
[143] *Id*. at *6 (quoting Hopp v. Rain, 88 N.W. 2d 39, 45 (Iowa 1958) (internal quotation marks omitted)).

In *Estate of Brown*,[144] the trustee of a testamentary trust appealed a trial court's order granting the lifetime and residual beneficiaries' petition to terminate a testamentary trust and distribute the proceeds to the life tenants. The primary issue raised was whether the trust continued to accomplish a material purpose.[145] The trust's primary purpose appeared to be providing for the education of the life tenant.[146] However, the trust also provided that once that purpose had been accomplished, the trust would continue to use income and principal as necessary "*for the care, maintenance and welfare of [the beneficiary and his wife] so that they ,nay live in the style and manner to which they are accustomed, for and during the remainder of their natural lives*."[147]

The court first held that the trust was neither a support trust nor a spendthrift trust; therefore, those were not unaccomplished material purposes preventing termination.[148] A support trust requires the trustee to use income and principal only to the extent necessary for support.[149] The trust was also not a spendthrift trust, even though the interests in the trust were not transferable.[150] Nevertheless, the court ruled that the trust had two material purposes: to provide for education and to assure life-long income for the beneficiaries through the trustee's management and discretion.[151] The language of the trust did more than create successive gifts; it provided for "the care, maintenance and welfare of [the lifetime beneficiaries] so that they may live in the style and manner to which they are accustomed, *for and during the remainder of their natural lives*."[152] The court held that the italicized language indicated a second and material purpose—providing a life-long income—that terminating the trust would defeat.[153]

Restatement (Third) of Trusts section 64 articulates the general rule that "the trustee or beneficiaries of a trust have only such power to terminate the trust or to change its terms as is granted by the terms of the trust."[154] If a third party has a power by the terms of a trust to terminate or modify the trust, the law presumes the third party holds the power in a fiduciary capacity.[155] Section 65 of *Restatement (Third) of Trusts* provides that "if all the beneficiaries of an irrevocable trust consent, they can compel the termination or modification of the trust."[156] However, if the modification or termination would be inconsistent with a material purpose of the trust, then the modification or termination requires the settlor's consent or, if the settlor is deceased, court approval upon a determination that the reason for termination or modification outweighs the material purpose.[157]

Comment *b* to section 65 of *Restatement (Third) of Trusts* confirms that the term *beneficiary consent* means the consent of all potential beneficiaries, even those who lack capacity.[158] Subsection (1) and comment *b* require the consent of all holders of powers of appointment, as well as the takers in default, except in the case of a presently exercisable general power of appointment.[159] Comment *b* acknowledges that consent may not be obtainable as a practical matter in many situations, although guardians ad litem,

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[144] 528 A. 2d 752 (Vt. 1987).
[145] *See id*. at 753.
[146] *See id*.
[147] *Id*. at 754 (emphasis in original).
[148] *See id*.
[149] *See id*.
[150] *See id*
[151] *See id*.
[152] *Id*. (emphasis in original omitted).
[153] *See id*.
[154] RESTATEMENT (THIRD) OF TRUSTS § 64 (2003).
[155] *See id*.
[156] *Id*. § 65.
[157] *See id*.
[158] *See id*. cmt. b.
[159] *See id*. § 65(1) & cmt. b.

court appointed representatives, or other beneficiaries who are representatives under the doctrine of virtual representation may be able to provide consent.[160] Comment *c* states that consent by representatives may present issues when such consent diminishes the represented beneficiaries' interests, such as with a termination.[161]

The material purpose restriction is interesting because it survives in many modern statutes. The material purpose restriction does not apply if the settlor is alive and able to waive it.[162] But the drafters intended the restriction to limit modification or termination by act of the beneficiaries "out of respect for serious objectives that appear to have motivated the settlor in creating the trust."[163] Comment *d* acknowledges that, under the *Claflin* doctrine, one cannot always easily distinguish between a material purpose and other specific intentions of the settlor that are deemed to be less important.[164]

> [T]he identification and weighing 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."[165]

Comment *d* also states that "[m]aterial purposes are not readily to be inferred."[166] Instead, a finding of a material purpose "requires some showing of a particular concern or objective on the part of the settlor, such as concern with regard to a beneficiary's management skills, judgment, or level of maturity."[167] A trustee's authority to terminate a trust early may indicate that retaining property in trust was not a material purpose and thus permit beneficiaries to consent to a termination earlier than the express terms of the trust otherwise provide. Comment *e* concludes that restraints on alienation—such as a spendthrift clause—or a trust that provides for support or other discretionary benefits may indicate a protective material purpose, in-consistent with permitting the beneficiaries to terminate the trust.[168] In some states, a trust is automatically spendthrift unless the settlor provides otherwise.[169] Comment e acknowledges that a spendthrift clause alone is insufficient to establish a material purpose to continue property in trust.[170] In contrast, a trust with broad discretionary powers may justify a finding that a material purpose of the trust was "to secure the ongoing, flexible and (possibly expert) judgment of the trustee regarding the amount, timing, and recipients of distributions over the duration of the trust."[171]

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[160] *See id*. § 65 cmt. b.
[161] *See id*. cmt. c. But *see id*. reporter's notes, cmts. b & c ("A representative's consent to a proposed modification or termination may also be facilitated: (i) by a life-insurance arrangement to cover the risk of a primary beneficiary's ... premature death ...; or (ii) by an indemnification agreement from the adult or primary remainder beneficiaries.").
[162] *See id*. § 65 cmt. d.
[163] *Id*.
[164] *See id*.; discussion supra Part III.A. 2.
[165] RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. d (2003).
[166] *Id*.
[167] *Id*.
[168] See *id*. cmt. e.
[169] *See, e.g*., Regan v. Ross, 691 F. 2d 81, 86 n.14 (2d Cir. 1982) (noting that "under New York law all express trusts are presumed to be spendthrift unless the settlor expressly provides otherwise").
[170] *See* RESTATEMENT (THIRD) OF TRUSTS § 65 cmt. e (2003).
[171] *Id*.

A modification that does not violate a material purpose of the trust may be easier to achieve than a termination.[172] In a modification, the focus is on the particular amendment sought.[173] Comment *h* confirms that a court may terminate or modify a trust to settle a bona fide dispute, notwithstanding that the termination or modification is inconsistent with a material purpose of the trust.[174]

The legacy of the *Claflin* doctrine may indicate greater potential tax consequences to beneficiaries who consent or fail to object to a termination, modification, or rescission of an irrevocable trust. The reason for these consequences is that consent or failure to object may constitute a waiver of valid rights under state law to avoid the relief requested. If such a waiver diminishes or eliminates a beneficial interest in an irrevocable trust, that reduction may be a taxable gift. The inquiry would be whether one construes the consent or failure to object as in the ordinary course of business—an arm's length transaction free of donative intent. Alternatively, perhaps one can successfully argue that the beneficial interest surrendered is of such nominal value that no gift tax would be imposed.

4. Equitable Deviation

The *Claflin* doctrine on modification and termination is distinct from the doctrine of equitable deviation, which allows a court, upon application by the beneficiaries, to deviate from the administrative terms of a trust if continued compliance, in light of changed circumstances unanticipated by the settlor, would defeat or substantially impair achieving the purposes of the trust.[175] Depending on state law, deviation might be difficult to achieve because a change in circumstances that makes deviation more advantageous to the beneficiaries may be held insufficient for relief, even if the change is relatively dramatic, such as the unanticipated special-needs status of a beneficiary.[176] Nevertheless, the standard for equitable deviation has relaxed. A court under a more modern standard may modify an administrative or distributive trust provision or direct or permit a trustee to deviate from an administrative or distributive provision if, because of changed circumstances not anticipated by the settlor, the modification or deviation will further the trust's purposes.[177]

Section 66 of *Restatement (Third) of Trusts* sets forth the modern doctrine of equitable deviation: "[a] court may modify an administrative or distributive provision of a trust, or direct or permit the trustee to deviate from an administrative or distributive provision, if because of circumstances not anticipated by the settlor the modification or deviation will further the purposes of the trust."[178] Section 66 imposes on the trustee an affirmative duty to seek judicial intervention regarding administrative provisions if circumstances arise justifying the relief and the trustee knows or should know that the circumstances could potentially cause substantial harm to the trust or its beneficiaries.[179] The reporter's note observes that the rule on equitable deviation in *Restatement (Second) of Trusts* section 167(1) was substantially more restrictive,

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[172] *See id*. cmt. f.
[173] *See id*.
[174] *See id*. cmt. h.
[175] *See* John K. Eason*, Private Motive and Perpetual Conditions in Charitable Naming Gifts: When Good Names Go Bad*, 38 U.C. DAVIS L. REV. 375, 437-38 (2005).
[176] *See, e.g.*, Appeal of Harrell, 801 P. 2d 852 (Or. Ct. App. 1990) (denying petition to modify trust under which special needs beneficiary would receive corpus outright upon the death of a senior generation of income beneficiaries because modification would defeat the special needs beneficiary's access to government benefits), *But see In re* Riddell, 157 P. 3d 888, 892 (Wash. Ct. App. 2007) (permitting modification to create a special needs trust for a mentally ill beneficiary because one of the trust's purposes was to provide for education, support, maintenance, and medical care and because federal law invited the creation of trusts of this kind).
[177] *See* Niemann v. Vaughn Cmty. Church, 113 P. 3d 463 (Wash. 2005) (permitting modification to trust where changed, unanticipated circumstances warranted equitable deviation from the trust's terms).
[178] RESTATEMENT (THIRD) OF TRUSTS § 66(1) (2003).
[179] *See id*. § 66(2).

permitting deviation only if the circumstances were unknown to and unanticipated by the settlor and compliance with the trust's terms would defeat or substantially impair the accomplishment of the trust's purposes.[180]

Because equitable deviation permits changes that affect only the administration of the trust, and not the beneficial interests, it should have limited tax risk for the beneficiaries.[181]

III. Modern View of Changing Irrevocable Trusts and Decanting

The Uniform Trust Code contains five separate provisions dealing with the reformation, modification, or termination of a trust, all of which appear in Article 4.[182] Some states have additional provisions. However, the most significant development is changing trusts by decanting.

New York was the first state to enact decanting legislation.[183] Although its provisions have been amended since it was first enacted in 1992, it essentially allows a trustee who has authority to invade the trust corpus for a beneficiary to pay the corpus over to another trust for the beneficiary. In other words, the trustee is pouring the assets of one trust into another as one might pour wine from one vessel to another—or, in other words, to decant. Despite the fact that New York adopted a statute, its legislative history provides that it is consistent with and declaratory of what likely is existing common law.[184] Indeed, the leading and earliest case that seems directly on point under common law is a Florida Supreme Court case, *Phipps v. Palm Beach Trust Company*,[185] which held that a trustee could invade trust property by paying it over to another trust for the beneficiary. [186]

A. Is an Invasion Power Anything More (or Less) than a Power of Appointment?

It seems that a power held by a trustee to invade the corpus of a trust is a power of appointment for property law purposes.[187] Indeed, as a general rule, the holder of a power of appointment may appoint the

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180 *See id*. § 66 reporter's notes; see also RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 12. 2 (2003) (permitting one to modify a donative document to achieve the donor's tax objectives, provided the modification does not violate the donor's probable intention).

181 *See, e.g.*, Treas. Reg. § 26. 2601-1(b)(4) (permitting modifications to the administrative provisions of a trust without adverse GST tax consequences).

182 *See* UNIF. TRUST CODE art. 4, 7C U.L.A. 477-519 (2006).

183 *See* New York Estates, Powers and Trusts Law 10-6.6. *See* A. Halperin & O'Donnell, "Modifying Irrevocable Trusts: State Law and Tax Considerations in Trust Decanting," 2008 University of Miami School of Law 42nd Annual Heckerling Institute.

184 Memorandum in Support of Legislation, Governor's Bill Jacket, 1992 Chapter 591, p. 4.

185 142 Fla. 782, 196 So. 299 (1940). *See also Wiedenmayer v. Johnson*, 106 N.J. Super. 161, 254 A.2d 534 (App. Div. 1968). Note however, that *Wiedenmayer* concerned an indirect decanting in that the trustees exercised their power of invasion in favor of the beneficiary contingent upon the beneficiary agreeing to transfer the property in further trust. The court concludes the transfer was in the beneficiary's best interests, describing "best interests" as follows: "The expression is not limited to a finding that distribution must be to the son's best 'pecuniary' interests. His best interests might be served without regard to his personal financial gain. They may be served by the peace of mind, already much disturbed by matrimonial problems, divorce and the consequences thereof, which the new trust, rather than the old contingencies provided for in his father's trust indenture, will engender. Of what avail is it to rest one's 'best interests' on a purely financial basis, and without regard to the effect upon a man's mind, heart and soul, if the end result would produce a wealthier man, but a sufferer from mental anguish?"

186 The discussion in this section was originally published in Zeydel & Blattmachr, *Tax Effects of Decanting - Obtaining and Preserving the Benefits*, 111 Journal of Taxation 288 (November 2009).

187 If the trustee can invade for his or her own benefit, then the power of invasion may constitute a general (estate taxable) power of appointment under sections 2514(c) and 2041(b) of the Code. The power to invade for one's own benefit (that is, to withdraw property from the trust) may cause the powerholder to be the owner of the trust for

property in further trust which is what a trustee with a decanting power may do.[188] That further suggests, if a decanting power is a power of appointment, that a trustee who may invade the corpus of a trust, unless the instrument provides otherwise, may pay it to a different trust for the benefit of the beneficiary or beneficiaries for whom it may be invaded.[189] Case law supports that conclusion. For example, as mentioned above, the Florida Supreme Court in 1940 in *Phipps* held that the trustee could invade the trust by paying the corpus to a new trust.

Nevertheless, there was no developed law about decanting in New York or in most other states when New York adopted its statute, which was the first decanting statute in the United States to be enacted. Even though the Florida Supreme Court had ruled that a trustee could transfer the property from the original trust to another pursuant to an absolute power of invasion, Florida later determined to adopt a decanting statute to clarify many aspects of decanting authority and its exercise. Hence, it may be preferable for the legislature of a state to adopt a decanting statute rather than rely on general principles of property law. Also, with heightened appreciation for the authority to distribute to new trusts, many practitioners now include decanting provisions in their trust forms.

In the *Phipps* case, the court cites to the Restatement of the Law of Trusts, Section 17, for the proposition that if a trustee has a special power of appointment, that is a power to appoint among the members of a specified class, then whether the trustee can effectively appoint a trustee for members of the class depends upon the terms of the power vested in the trustee. Accordingly, the court concludes that the general rule is as follows:

> The general rule gleaned from the foregoing and other cases of similar import 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.

Because the power to decant is deemed held by the trustee, it is by definition a fiduciary power. The *Comments* to Restatement (Third) of Trusts §75 draw a distinction between powers held in a fiduciary capacity, and those that are held for the powerholder's own benefit. The discussion echoes that in the *Comments* to §64 which cite to authorities that draw a distinction between a personal power that may be exercised for the personal benefit of the donee of the power and a fiduciary power which must be exercised for the purpose for which the settlor created it. Accordingly, it would appear that if the powerholder's power is personal, then the trustee's only duty is to ascertain whether the attempted exercise is or is not within the scope of the power.

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purposes of section 671 of the Code so that the income, deductions and credits against tax of the trust are attributed to the powerholder. *See* section 678(a). However, if the power is held in a fiduciary capacity, section 678 should not apply. See discussion in J. Blattmachr, M. Gans & A. Lo, "A Beneficiary as Trust Owner: Decoding Section 678" to be published in the ACTEC Journal, Fall 2009.

[188] *See, generally, Scott on Trusts* §3.1.2 at 144–45 (5th ed. 2008) (the trend is to construe the language conferring a power of appointment with increasing liberality, and to hold that the donee of the power has broad discretion as to the manner in which the power may be exercised).

[189] *See, e.g.,* Restatement (Third) of Property (Wills & Don. Trans.) § 19.14 (2011) (Except to the extent that the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment in any form, including one in trust and one that creates a power of appointment in another, that only benefits permissible appointees of the power.) *See also* § 19.15 (*e. Appointment in trust.* The donee of a power to appoint may make an appointment in trust for the benefit of permissible appointees, unless the donor has manifested an intent to exclude an appointment in trust (see § 19.14). An appointment in trust necessarily involves a nominal direct appointment to an impermissible appointee, unless the trustee is a permissible appointee of the power. The appointment to an impermissible appointee-trustee, however, does not give the impermissible appointee a beneficial interest and hence does not violate the rule of this section.)

The foregoing distinction between personal and fiduciary powers may explain why the *Restatement (Third) of Property (Wills & Don. Trans.)* § 17.1 (2011) clarifies that a fiduciary distributive power is a power of appointment but is not a discretionary power of appointment that may be exercised arbitrarily as long as it is within the scope of the power.[190] The donee of a power of appointment would seem to have no affirmative duty to act in good faith and could exercise a power of appointment to exclude a person from beneficial enjoyment for personal reasons.[191] A fiduciary, on the other hand, would be precluded by fiduciary duties from acting in a similar manner. Instead, a fiduciary would seem always to be held to a minimum standard of good faith, with an obligation to act consistently with the terms of the trust and the interests of the beneficiaries.[192]

B. Goals Sought in Decanting a Trust and What the Courts Have Approved

Although the original New York decanting statute was enacted principally to confirm the authority of a New York trustee to exercise an invasion power in further trust for generation-skipping transfer tax purposes,[193] the New York courts subsequently approved decanting for numerous other reasons. Because the original New York statute required court approval in order for a trustee to decant, a small body of case law developed providing guidance as to the scope of decanting authority. The goals or purposes of using decanting include:

1. addressing changed circumstances, such as changes in applicable fiduciary or tax law or changes in family circumstances or dynamics;

2. protecting the tax treatment of a trust (*Matter of Ould,* NYLJ November 28, 2001, p. 21, col. 5 (Surr. Ct. NY County) in which the trustees were permitted to appoint the trust estate consisting of a second to die insurance policy to a new trust thereby eliminating the *Crummey* power of withdrawal of one of the insureds);

3. modifying administrative provisions, such as restrictions on investment powers or to create a directed trust;

4. granting a beneficiary a power of appointment, presently exercisable or otherwise[194];

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[190] Comment *g* states "*g. Fiduciary distributive powers.* A fiduciary distributive power is a power of appointment (a nongeneral power), but it is not a discretionary power of appointment. In the case of a discretionary power of appointment, which is the principal subject of this Division, the donee may exercise the power arbitrarily as long as the exercise is within the scope of the power. ... In the case of a fiduciary distributive power, the fiduciary's exercise is subject to fiduciary obligations as provided in the Restatement (Third) of Trusts." *citing* RESTATEMENT (THIRD), TRUSTS §§ 86 and 50, Comment a.

[191] *See* RESTATEMENT (THIRD) OF TRUSTS § 50 (2003), Comment *a*: "A trustee's discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power."

[192] *See* UNIF. TRUST CODE § 105 (NAT'L CONF. OF COMM'RS. ON UNIF. STATE LAWS 2010) which prohibits a trust instrument from exonerating a trustee's duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

[193] *See* Turano Supplementary Practice Commentary, McKinney's Cons. Laws of N.Y. Book 17B, EPTL 10-6.6 [1992], at 24.

[194] *See Phipps v. Palm Beach Trust Co.,* 196 Fla. 782 (1940). Granting a beneficiary a power of appointment not only will allow the beneficiary to change the remainder or other successor beneficiaries but also to expose property to estate rather than generation-skipping transfer tax such as where the beneficiary is given a general power of appointment or a special power that can be used to trigger the "Delaware tax trap" under I.R.C. § 2041(a)(3). *See* J. Blattmachr & J. Pennell, "Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes," 68 Journal of Taxation 242 (April 1988), updated and reprinted in 24 Real Property Probate and Trust Journal 75 (Spring 1989).

5. reducing administrative costs (*Matter of Vetlesen*, NYLJ June 29, 1999, p. 27, col. 3 (Surr. Ct. NY County) in which a sole trustee appointed principal of an *inter vivos* trust to himself and another as trustees of a testamentary trust and the trustees agreed to share one commission);

6. altering trusteeship provisions such as the identity or manner of appointing fiduciaries (*Matter of Klingenstein*, NYLJ April 20, 2000, p. 33, col. 6 (Surr. Ct. Westchester County) in which limitations on number of individual trustees, powers to remove and replace trustees, requirement for a corporate trustee, designation of successor trustees and ability of corporate trustee to appoint a successor were changed);

7. extending the termination date of a trust (*In re Alfred Hazan*, NYLJ April 11, 2000 (Surr. Ct. Nassau County) in which a trustee was permitted to extend a trust for a beneficiary's lifetime; *see* also *Matter of Dornbush (Riese),* 164 Misc. 2d 1028, 627 N.Y.S. 2d 232 (Surr. Ct. NY County 1995), in which the trustees of an irrevocable trust subject to New York law which was to end at the first to die of the grantor and the beneficiary was paid to a new Florida trust for the beneficiary's lifetime in order to protect the trust assets from the beneficiary's potential creditors);

8. converting a non-grantor trust to a grantor trust or the reverse;[195]

9. changing a trust's governing law (*Matter of Dornbush (Riese), supra,* in which the trustees of two irrevocable trusts subject to New York law were allowed to pay over assets to substantially identical Florida trusts in order to protect the trust's assets from New York real property transfer gains taxes);

10. dividing trust property to create separate trusts;

11. reducing potential liability (*Matter of Kaskel*, 163 Misc. 2d 203, 620 N.Y.S.2d 217 (Surr. Ct. NY County 1994) in which the trustees of several family trusts, which included spendthrift provisions, were allowed to terminate the existing trusts and pay over assets to new trusts without spendthrift provisions so that the beneficiaries could assign their interests in distressed real estate properties from the trusts to corporations followed by an invasion of the principal of the trusts in favor of the corporation);

12. converting a trust into a supplemental needs trust to permit a beneficiary to qualify for certain governmental benefits (*Estate of Grosjean,*, NYLJ December 10, 1997, p. 35, col. 6 (Surr. Ct. Nassau County)*; see also In re Estate of Alfred Hazan, supra; Estate of Barkman,* NYLJ May 20, 2003, p. 23, col. 3 (Surr. Ct. Nassau County)*,* in which remarkably the court permitted the conversion even though the beneficiary had a fixed income interest*)*;

13. making a trust interests spendthrift or the reverse (*Matter of Rockefeller*, NYLJ, August 24, 1999, p. 28, col. 2 (Surr. Ct. Nassau County) in which a committee of individuals

[195] Converting a trust into a grantor trust allows the trust to grow on an income tax free basis, a great benefit for the trust and its beneficiaries. However, the grantor's income tax will increase and those statutes that prohibit any adverse tax effect may block a trustee from converting a trust into a grantor trust or the reverse. *See* CCA 200923024 (not precedent) holding that the mere conversion of a non-grantor trust to a grantor trust is not a transfer for income tax purposes requiring the recognition of gain. Grantor trust status also would permit the trust and the grantor to buy and exchange assets between themselves without gain. *See* Rev. Rul. 85-13, 1985-1 CB 142. It may also expose the trust to or eliminate the application of state and local income taxation.

with discretionary distribution authority over a trust was permitted to pay trust assets to a new trust to protect the trust principal by providing a spendthrift restraint); and

14. correcting a drafting error without the necessity of going to court.

The authority to decant under New York law was not without limitations. In *Estate of Mayer,*[196] the court denied the authority to decant in the case of a testamentary sprinkling trust which authorized the independent trustee to distribute principal "in [his] sole and absolute discretion, [as he] may deem necessary for the *health, support, maintenance and education of any person or persons who may at such time be a person or persons eligible to receive income from the trust . . "* At the time the New York statute permitted decanting only in the case of an absolute discretion trust. The court concludes that "absolute" discretion connotes a standard that is unconstrained except by the implicit requirements of reasonableness and good faith. The court held that the proposed invasion was in essence a request to invade for estate planning purposes (the petitioners alleged that it would permit the reduction of taxes) and outside the parameters established by the testator, "even when reviewed with the greatest possible leniency."

C. More Recent Decanting Cases

Propelled in part by the Uniform Trust Decanting Act published by the Uniform Law Commission in 2018, a majority of States have enacted an express decanting statute. But in those States without a decanting act, the authority to decant may be supported under the common law.

1. Morse v. Kraft

In *Morse v. Kraft*,[197] the Massachusetts Supreme Judicial Court, in an action brought by the trustee for declaratory relief, became the second court squarely to address whether, under common law, the trustee of a discretionary trust has the power to exercise the trustee's discretion by distributing trust property to a new trust for the beneficiaries of the original trust, without the beneficiaries' consent or court approval. Although the *Morse* court determined that the trustee had the authority to decant, the *Morse* decision could be perceived as far narrower than most would have liked. The court was particularly focused on the discretionary language in the trust instrument expressly permitting distributions "for the benefit" of the beneficiaries, and indicated that given the widespread awareness of decanting, a more recent trust instrument without express decanting authority may create a negative inference that the settlor intentionally omitted the power.[198]

Note that the *Phipps* formulation of a trustee's authority to distribute in further trust was that a trustee with absolute discretion to distribute trust property "to" its beneficiaries could appoint the entire trust to another trust "for" its beneficiaries. An interesting aspect of the *Phipps* opinion is that the second trust in question granted the primary beneficiary of the first trust a testamentary power of appointment in favor of the beneficiary's spouse who was not a beneficiary under the first trust. The granting of a testamentary power of appointment in favor of persons who were not beneficiaries under the first trust would appear to derive from the trustee's ability to distribute property outright to a beneficiary, after which the beneficiary could certainly deflect the property to whomever the beneficiary might choose. [199]

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[196] 176 Misc.2d 562, 672 N.Y.S.2d 998 (Surr. Ct. NY County 1998).
[197] *See Morse v. Kraft*, 466 Mass. 92 (2013).
[198] The court repeatedly cited W. Culp & B. Mellen, "Trust Decanting*:* An Overview and Introduction to Creating Planning Opportunities," 45 RPTELJ 1 (Spring 2010) and D. Zeydel & J. Blattmachr, "Tax Effects of Decanting – Obtaining and Preserving the Benefits," 111 JTAX 288 (November 2009).
[199] *Id.* at 787, 301.

In affirming that decanting authority exists under the common law, the Florida Supreme Court in the *Phipps* opinion held that,

> [t]he general rule gleaned from … cases of similar import 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.[200]

The court in *Phipps* rejected the respondent's argument that the reverse was true, i.e., that the power to create a second trust estate is present under a special power of appointment only where such authority is specifically granted.[201] The court relied on the Restatement of the Law of Trusts, section 17, for the proposition that if a trustee has a special power of appointment, that is a power to appoint among the members of a specified class, then whether the trustee can effectively appoint a trustee for members of the class depends upon the terms of the power vested in him. Thus, the court concluded that, so long as the beneficiaries of the second trust are limited to the class of beneficiaries under the first trust, the power in the trustees to appoint in further trust, much like a power of appointment, is absolute, and to hold otherwise would limit the power of the individual trustee to administer the trust estate in a way not contemplated by the donor of the first trust.

The court in *Morse* declined to follow *Phipps* to that degree. Instead, the court was more inclined to adopt the reasoning of *Wiedenmayer v. Johnson*,[202] wherein the court, finding the trustee to have absolute and uncontrolled discretion, permitted a decanting for the beneficiary's "best interests". Although *Wiedenmayer* is cited as a decanting case, *Wiedenmayer* actually concerned an indirect decanting in that the trustees exercised their power of invasion in favor of the beneficiary contingent upon the beneficiary agreeing to transfer the property in further trust. The court concludes the transfer was in the beneficiary's best interests, describing "best interests" as follows:

A power held by a trustee to invade the corpus of a trust closely resembles a power of appointment for property law purposes.[203] Indeed, as a general rule, the holder of a power of appointment may appoint the property in further trust, which is exactly what the trustee possessing a decanting power does.[204] The court in *Morse* cited its prior decision prospectively authorizing the donee of a non-fiduciary power of appointment to exercise the power in further trust in support of its conclusion that a trustee with discretionary distribution authority may do the same.[205] This connection further suggests that if a decanting power is similar to a power of appointment, then, unless the instrument provides otherwise, a trustee who may invade the corpus of a trust may pay it to a different trust for the benefit of the beneficiary or

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[200] *Id.* at 786, 301.

[201] *Id.*; *see also* BOGERT'S TRUSTS AND TRUSTEES (through 2011 Update), Chapter 39, § 812, under the discussion of the express (and unlimited by an ascertainable standard) power in the Trustees to distribute principal.

[202] 106 N.J. Super. 161, 254 A.2d 534 (App. Div.), *aff'd sub nom., Wiedenmayer v. Villaneuva,* 55 N.J. 81, 259 A.2d 465 (1969).

[203] If the trustee can invade for his or her own benefit, then the power of invasion may constitute a general (estate taxable) power of appointment under Sections 2514(c) and 2041(b). The power to invade for one's own benefit (that is, to withdraw property from the trust) may cause the powerholder to be the owner of the trust for purposes of Section 671 so that the income, deductions and credits against tax of the trust are attributed to the powerholder. *See* I.R.C. § 678(a). However, if the power is held in a fiduciary capacity, Section 678 may not apply. See discussion in Blattmachr, Gans & Lo, *"A Beneficiary as Trust Owner: Decoding Section 678,"* ACTEC JOURNAL, Fall 2009.

[204] *See, generally,* SCOTT ON TRUSTS §3.1.2 at 144–45 (5th ed. 2008) (the trend is to construe the language conferring a power of appointment with increasing liberality, and to hold that the donee of the power has broad discretion as to the manner in which the power may be exercised).

[205] *Loring v. Karri-Davies*, 371 Mass. 346, 357 N.E.2d 11 (1976).

beneficiaries for whom it may be invaded, even if the power to invade does not specifically state it may be exercised "for the benefit of" the beneficiary.[206]

The *Morse* court states that "[a] trustee can only exercise a decanting power, however, in keeping with fiduciary obligations." Although the court finds that decanting authority was present, the court states in a footnote that it is not passing judgment on whether the transfer of assets to the new subtrusts was, in fact, in the beneficiaries' best interests or in keeping with the trustee's fiduciary duties. The court considered only the question of whether the trust authorizes such a transfer. This holding appears to raise the question of whether the decanting may have been avoided by the beneficiaries, nonetheless, as a breach of trust, which could, at a minimum, have tax consequences to the beneficiaries who fail to object.[207] Whether the exercise of authority that turns out to be a breach of trust can satisfy the exception under the generation-skipping transfer tax regulations seems doubtful.[208]

2. In Re Kross

In re Kross,[209] the Trustees sought approval for invading a trust for the benefit of a beneficiary with disabilities to ensure qualification for Medicaid and Supplemental Security Income benefits. The Attorney General of the State of New York on behalf of the New York State Department of Health objected. The invaded trust was a fully discretionary trust as to income and principal payments until the beneficiary attained age 21, whereupon the beneficiary would become entitled to income in quarterly installments and principal one-third at age 25, one-half the balance at age 30 and the remainder at age 35. At issue was the validity of the notice of decanting and waiver of the thirty-day notice period under the New York statute. The Trustees gave notice less than thirty days prior to the date the beneficiary attained age 21. The beneficiary's father (who was neither the grantor nor a Trustee) executed a consent to the decanting taking effect immediately. The beneficiary's father was expressly authorized to receive notice and consent on behalf of the beneficiary by the trust agreement. Accordingly, the court found the consent to be valid and effective to permit the decanting to take place five days after notice was given and prior to the beneficiary attaining age 21.

3. Ferri v. Powell-Ferri

In *Ferri v. Powell-Ferri*,[210] one of the parties to a proceeding for dissolution of marriage was the beneficiary of a third party trust. The trust was governed by Massachusetts law and provided that upon attaining age 35, the beneficiary would have periodically increasing rights to withdraw principal from the trust. At the time divorce proceedings were initiated, Ferri had the right to withdraw 75% of the trust estate. During the pendency of the proceedings, his withdrawal right would have increased to 100%. The Trustees of the trust, after the divorce proceedings commenced, decanted the trust to a new trust that eliminated the current and future withdrawal rights, and included spendthrift provisions. The Trustees instituted a declaratory action seeking a ruling that they had validly exercised their authority to transfer the assets to the new trust and that the beneficiary's spouse had no interest in the assets of the new trust. The beneficiary's spouse asserted claims of fraud, conspiracy and breach of the requirement not to dissipate marital assets. The court found that because the beneficiary did not participate in the decanting, the

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[206] *See, e.g.,* RESTATEMENT (THIRD) OF PROPERTY (WILLS & OTHER DONATIVE TRANSFERS) § 19.14 (2011) (except to the extent the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment, including one in trust and one that creates a power of appointment in another, that solely benefits permissible appointees of the power.)

[207] *See generally,* D. Zeydel, "Developing Law on Changing Irrevocable Trusts*:* Staying Out of the Danger Zone," *47 Real Prop. Tr. & Est. L.J. 207* (2012).

[208] *See* Regs. § 26.2601-1(b)(4)(i)(A)*(1)(i)*

[209] 2013 WL 5478190 (Surr. Ct. NY Cty 2013).

[210] 326 Conn. 457 (2017) and 326 Conn. 438 (2017).

beneficiary had no duty to thwart the removal of assets from the marital estate by the Trustees. In addition, the beneficiary had no affirmative duty to recover the marital assets "taken by a third party."

As in *Morse v. Kraft*, the Massachusetts court refused to recognize a common law authority to decant, but rather, looked to the specific language of the governing instrument to determine whether the settlor intended to confer such authority. The court focused on the language stating that so long as the beneficiary is living, the trustee shall "from time to time, pay to *or irrevocably segregate for later payment to* [the beneficiary] as much of the net income and principal of the trust as [the trustee] shall deem desirable for [the beneficiary's] benefit." (Emphasis added). Powell-Ferri argued that the withdrawal powers held by Ferri were wholly inconsistent with the trustee's authority to decant. The court disagreed because it would follow that the trustee would lose the ability to administer the assets subject to withdrawal, which would make little sense in view of the language giving the trustee authority to pay to or segregate assets for later payment to the beneficiary during the beneficiary's lifetime. The court pointed out that the trustees continued to hold legal title to the assets, notwithstanding the withdrawal rights, and therefore, had all the authority to administer those assets conferred by the trust agreement. Nonetheless, because the governing instrument did not contain an express authorization to decant, the court found that there to be an ambiguity, permitting consideration of the settlor's affidavit which confirmed his intention that the trustees were authorized to take any action necessary to protect the principal and income of the trust which authority also extended to protecting the assets from the creditors of the beneficiary.

The *Ferri* case might seem incorrect to some, and certainly most decanting statutes do not permit decanting of assets subject to a presently exercisable power of withdrawal, whether a *Crummey* power or a power such as the one held by Ferri. Nonetheless, the Massachusetts court's interpretation of the Ferri trust turned out to be very beneficial to Ferri, as it prevented the trust estate from being considered a marital asset. How important it may have been to the court that the trust estate was largely accumulated during the marriage, and used for investments in franchises, is unknown. The Connecticut court repeated several times that Ferri did not instigate the decanting, or even know about it.

The *Ferri* cases certainly demonstrate the potential benefits of a decanting power, and confirm the holding of *Phipps* that the ability to distribute in further trust derives from the trustee's broad discretion to distribute outright on a principle that the greater includes the lesser. Accordingly, even without express language in the governing instrument, or a state statute, decanting should not be overlooked as a powerful solution that in many ways may be more flexible that a court ordered modification or reformation.

4. Hodges v. Johnson

Not all decantings will pass muster, however. In *Hodges v. Johnson,*[211] the settlor created two trusts for his wife, children and step-children and their descendants. The trust agreements expressly authorized discretionary distributions to the beneficiaries and to "distributee trusts." There were disputes within the family concerning the family business, and the settlor approached the trustees about decanting the trusts to exclude certain of the beneficiaries. The trial court found that the decantings were accomplished without consideration of the plaintiffs' beneficial interests, and therefore, held them to be invalid. The trial court implied that the decantings were accomplished solely to achieve the settlor's desires, without consideration of the interests of the beneficiaries. The Supreme Court held that the trustees were required to give "due regard for the diverse beneficial interests created by the terms of the trusts" and that the trustees breached their duty of impartiality because the trustees failed to treat the beneficiaries equitably in light of the purposes and terms of the trusts. In addition, the court also affirmed the removal of the trustees who engaged in the decanting for cause. The good news is that *Hodges* confirms that decanting is a fiduciary power, subject to review for breach of trust. Accordingly, decanting is properly viewed as the

[211] 7th Cir. Ct. - Dover Probate Division, No. 2016-0130 (Sup. Ct. N.H. 2017).

exercise of discretion by the trustee under the trustee's authority to make distributions, and not as an act by the beneficiaries or the settlor to change the beneficial interests under a trust.

5. In Re Matter of Niki and Darren Irrevocable Trust

In *In re Matter of Niki and Darren Irrevocable Trust,*[212] the settlor and the successor trustee tried to undo a prior decanting undertaken by them on the basis that it violated the Delaware decanting statute. The settlor created a trust for her own benefit that was governed by California law. Under the original trust, the settlor was the sole trustee and retained the right to income, but apparently had no authority to invade principal for her own benefit. Upon her death, the original trust was to continue in two further trusts, one for her daughter, Niki, and one for her son-in-law, Darren. The settlor changed the situs of the trust to Delaware and appointed Comerica Bank & Trust, N.A. as a co-trustee. The settlor then created a second trust which provided that in the event that Niki and Darren were to divorce, Darren's remainder interest would be accelerated and paid to him outright during the settlor's lifetime. The settlor and Comerica decanted the original trust to the second trust. The settlor, Niki and Darren all signed acknowledgements and statements of non-objection or consent to the decanting.

Subsequently, Niki and Darren did divorce, and the settlor and Comerica attempted to set aside the earlier decanting. On the basis of the doctrine of unclean hands, the court denied the relief, although the court stated that if Niki were to petition, she would not be subject to the doctrine, although it seems she might be thwarted by her prior consent.

Note the court pointed out the decanting was in fact invalid under the Delaware statute, not only because a decanting requires authority to invade the principal of the trust,[213] but also because under Delaware law, only the beneficial interests of persons who are potential objects of a principal invasion may be amended by a decanting. If the trust is not fully distributed to those persons, then the trust may continue the interests of the remainder persons of the original trust, but may not modify them.

6. Matter of Bruce R. Evertson Dynasty Trust

In *Matter of Bruce R. Evertson Dynasty Trust*,[214] the Trustee petitioned the court for instructions on the validity of a decanting under Wyoming law and the trust agreement. The court concluded that in an action for judgement on the pleadings, the court may not make factual findings. However, in the case of an unambiguous trust agreement, the court may find that the trustee has decanting authority. Note that it is not possible in all jurisdictions for a trustee to seek instructions from a court or approval of a proposed course of action that is discretionary. In *Matter of Evertson,* relying on the Restatement (Third) of Trusts § 71 and Restatement (Second) of Trusts § 259, the court concludes that a trustee may apply to an appropriate court for instructions regarding the administration or distribution of a trust if there is reasonable doubt about the powers or duties of the trusteeship or about the proper interpretation of the trust provisions and that a trustee is also entitled to apply to court for instructions as the administration of the trust if there is reasonable doubt as to the duties or powers of the trustee.

[212] 2020 WL 8421676 (DE Court of Chancery 2020).
[213] *See also* In re Estate of Sibley (246 Ariz. 498 (2019) (holding that a power to appoint under the Arizona decanting statute arises only when the trustee has discretion to make distributions.
[214] 446 P.3d 705 (Supreme Court of Wyoming 2019).

IV. The Completed Transaction Doctrine and Its Impact

Although permitted under state law, the act of rescinding, reforming, modifying, or terminating a trust may nevertheless have adverse tax consequences.[215] If the tax event has already taken place, an attempt to undo the action giving rise to tax consequences may fail.[216] As a general rule, a judicial reformation or other action will not change the tax consequences if the transaction in question is already complete.[217] The so-called "completed transaction" doctrine states that one cannot unwind the tax consequences of a transaction that has already taken place.[218]

Courts have consistently held that retroactive changes to the legal effects of a transaction through judicial nullification of a transfer or judicial reformation of a document do not have retroactive effect for federal tax purposes.[219]

The court in *Van Den Wymelenberg* focused on the attempt to effectuate retroactive tax consequences by amendments and reformations of gifts by order of a state court in a nonadversarial proceeding.[220] The court required the Service to be a party to the proceeding to avoid the possibility of collusion, which had the effect of usurping a federal interest in collecting tax because all parties to the proceeding had a common interest in minimizing the federal tax liability."[221] On the other hand, cases such as *Dodge v. United States*,[222] examine the transaction from the standpoint of whether a completed gift occurred when the donor, based on a mistake, transferred property that the donor did not intend to transfer. Under *Dodge*, the transfer is incomplete because the donor, having a remedy in state court to undo the mistake, had not given up dominion and control of the property, and thus Treasury Regulation section

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[215] *See*, *e.g*., Van Den Wymelenberg v. United States, 397 F. 2d 443,446 (7th Cir. 1968) (holding that amended trust agreement did not retroactively determine federal gift tax consequences).
[216] *See id*. at 445.
[217] *Id*.
[218] *See id*. at 443; Am. Nurseryman Publ'g Co. v. Comm'r, 75 T.C. 271 (1980), *aff'd without published opinion*, 673 F. 2d 1333 (7th Cir. 1982).
[219] *See Am. Nurserymen? Publ'g Co*., 75 T.C. at 276-77 (1980) (holding nunc pro tune voiding of transfer that otherwise destroyed S-corporation election entered in state court action to which the United States was not a party did not affect federal income tax liability for already completed years); Estate of Hill v. Comm'r, 64 T.C. 867, 879 (1975), *aff'd without published opinion*, 568 F. 2d 1365 (5th Cir.1978); Emerson Inst. v. United States, 356 F. 2d 824, 826-27 (D.C. Cir. 1966) ("[T]he law appears well established that a none pro tune decree in proceedings to which the.... Service is not a party is not binding on that Service for tax purposes... [The] decree could, at best, have operative consequences only as between the parties to the action in which it was entered." (citations omitted)); Piel v. Comm'r, 340 F. 2d 887, 891 (2d Cir. 1965); M.T. Straight Trust v. Comm'r, 245 F. 2d 327, 329-30 (8th Cir. 1957) (declining to alter federal tax liability that had accrued on the ground that nunc pro tune reformation of trust does not alter the federal tax liability where United States is not made a party to the reformation action and holding "that it is both inequitable and beyond the power of a State Court to change retroactively the status of a federal revenue measure with a resulting loss of revenue to the government"); Eisenberg v. Comm'r, 161 F. 2d 506, 511 (3d Cir. 1947); Sinopoulo v. Jones, 154 F. 2d 648, 651 (10th Cir. 1946); Rev. Rul. 93-70, 1993-2 C.B. 269 (concluding that the retroactive reformation of a trust instrument to eliminate a provision permitting distributions to persons other than the income beneficiary would not retroactively cause the trust to be a qualified subchapter S trust within the meaning of Code section 1361(d)(3)). *See generally* Barry F. Spivey, *Completed Transactions, Qualified Reformation and Bosch: When Does the IRS Care about State Law of Trust Reformation?*, 24 ACTEC L.J. 345 (2001) (asserting that retroactive changes have consistently had no retroactive effect for federal tax purposes).
[220] 397 F. 2d 443 (7th Cir. 1968).
[221] *See id*. at 445 (denying retroactive tax consequences to amendments and reformation of gifts by state court in no adversarial proceedings when there is an issue of collusion and holding that "not even judicial reformation can operate to change the federal tax consequences of a completed transaction").
[222] 413 F. 2d 1239 (5th Cir. 1969).

25.2511-2 precluded the making of a completed gift.[223] In *Dodge*, the Service was a party to the proceeding.[224] Taxpayers have been more successful recently, particularly in Massachusetts.[225]

Some suggest that a mistake involving the wrong asset differs from a mistake of law, but courts tend to permit rescission based upon either type of mistake. In *Breakiron v. Gudonis*, the court stated "the mistake was not a mere 'scrivener's error,' [but] it was a mistake at the time [of disclaimer] — not a hindsight decision by plaintiff to avail himself of a tax advantage."[226] If, as the court found, state law permits such a rescission,[227] can one conclude that the donor has not parted with dominion and control because the donor possesses the state law right to retrieve the property based upon the mistake of law and unintended tax consequences? This appears to be the logic of *Breakiron*.

In *Berger v. United States*,[228] the court held that a mistaken transfer was not a completed gift by virtue of the equitable right of reformation.[229] Misunderstanding the conflict rules pertaining to political appointees, the taxpayer sought political appointment, liquidated his property, and transferred it to two irrevocable trusts for the benefit of his wife and children.[230] The taxpayer then sought judicial reformation of the trusts to make them revocable, which the court granted.[231] The district court held that the gift into trust was incomplete for mistake and thus not subject to transfer tax.[232] Note that the UTC expressly permits modifications to achieve a settlor's tax objectives as long as those modifications are not contrary to the settlor's probable intent.[233]

In *Neal v. United States*, the U.S. Court of Appeals for the Third Circuit similarly affirmed a district court decision granting the taxpayer a refund of gift taxes paid when she acted under a mistake of law.[234] The taxpayer, a trust grantor, released all of her contingency reversionary interest in her GRIT and then attempted to rescind her action.[235] Because she was mistaken as to what effect the law would have on her

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[223] *See id*. at 1243.
[224] *See id*. It would not appear that the taxpayer has the ability to make the Service a party to any proceeding. *See* Spivey, *supra* note 299, at 346.
[225] *See* Breakiron v. Gudonis, No. 09-10427-RWZ, 2010 WL 3191794 (D. Mass. Aug. 10, 2010) (permitting the rescission of tax defective disclaimer of remainder interest in QPRT to avoid a $2. 3 million gift tax liability); Kaufman v. Richmond, 811 N.E. 2d 987 (Mass. 2004) (disclaimer of inherited property reformed so that it would not exceed decedent's remaining GST exemption); DiCarlo v. Mazzarella, 717 N.E. 2d 257 (Mass. 1999) (allowing reformation of scrivener's error when "clear and decisive proof" showed settlor intended to qualify for federal estate tax marital deduction); *see also* Neal v. United States, 83 A.F.T.R. 2d 99-2325, 99 -2327 (3rd Cir. 1999) (holding that rescission for mistake of law eliminated gift tax liability); First Security Bank v. United States, No. CIV. 99-1298, MV/DJS (D.N.M. Apr. 30, 2001) (holding that transfer in trust for husband was incomplete and therefore voidable under New Mexico law because it was implicitly conditioned upon a timely execution of a QTIP marital deduction election), *reversed sub nom*. Wells Fargo Bank N.M., N.A. v. United States, 319 F. 3d 1222 (10th Cir. 2003); Griffin v. Griffin, 832 P. 2d 810 (Okla. 1992) (holding that evidence of mistake clear and tax objectives can be considered in determining intent and reforming trust to delete language objectionable for marital deduction purposes).
[226] *Breakiron*, 2010 WL 3191794, at *6.
[227] *See id*. at *3.
[228] 487 F. Stipp. 49 (W.D. Pa. 1980).
[229] *See id*. at 52.
[230] *See id*. at 50.
[231] *See id*.
[232] *See id*. at 52.
[233] *See* UNIF. TRUST CODE § 416, 7C U.L.A. 516 (2006).
[234] Neal v. United States, 83 A.F.T.R. 2d 99-2325, 99-2325 (3d Cir. 1999).
[235] *See id*. at 99-2326.

tax liabilities, both the state and federal courts found she originally released her interests under a mistake of law and as such could rescind her actions, resulting in the tax refund.[236]

On a number of occasions, the Service has ruled in favor of permitting the reformation of an irrevocable trust to have retroactive effect.[237] In Private Letter Ruling 200219012, the Service ruled that a state court's rescission of a charitable remainder trust would be recognized as effective as of the date of the trust's creation where the beneficiary charity had incorrectly (though apparently innocently) represented the tax treatment of the transfer to the trust.[238] In Private Letter Ruling 200106008, the Service ruled that a court order reforming a will based on a scrivener's error is consistent with state law as the state's highest court would have applied it.[239] Accordingly, the Service recognized that the surviving spouse had a qualifying income interest for life for purposes of the federal estate tax marital deduction.[240] The error arose out of the inclusion of language permitting discretionary payments of principal to the deceased spouse's descendants, which language the reformation removed upon the Service's determining that the decedent intended the invasion provision to apply only to the residuary, nonmarital trust.[241]

In Private Letter Ruling 200144018, the Service approved reformation of a scrivener's error, and thus the decedent neither held nor released a general power of appointment.[242] The Service stated that "if, due to a mistake in drafting, the instrument does not contain the terms of the trust that the settlor and the trustee intended, the settlor or other interested party may maintain a suit in equity to have the instrument reformed so that it will contain the terms that were actually agreed upon."[243]

Apparently, the modern interpretation of the completed transaction doctrine permits alteration, without adverse tax consequences, of a transaction that otherwise appears complete if the taxpayer can demonstrate that due to a mistake of fact or law, the transaction has an effect the transferor did not intend at the time of the transfer. The notion is that because the transferor has available the remedy of rescinding or modifying the transaction under state law as a result of the mistake, the transaction is incomplete for gift tax purposes. Moreover, Revenue Ruling 81-264 might apply to this scenario by analogy. Just as the loan at issue in the ruling did not become a gift until the loan's statute of limitations ran, a transfer that one may rescind under state law might remain an incomplete gift until the right to rescind expires.[244]

A. *Bosch* and the Importance of State Law

In *Commissioner v. Estate of Bosch*,[245] the Supreme Court concluded that a state trial court's determination of a property interest does not conclusively bind federal authorities, including the Service, when the state trial court makes the determination in a proceeding to which the United States is not a party. This holding echoes *Van Den Wymelenberg*'s statement that a proceeding to which the Service is not a party is potentially collusive and should not usurp a federal interest in collecting tax.[246] In a case

[236] *See id*. at 99-2327 to -2328.
[237] *E.g*., Priv. Ltr. Rul. 200219012 (May 10, 2002); Priv. Ltr. Rul. 200106008 (Feb. 9, 2001); Priv. Ltr. Rul. 200144018 (Nov. 2, 2001).
[238] *See* Priv. Ltr. Rul. 200106008 (Feb. 9, 2001)
[239] *See id*.
[240] *See id*.
[241] *See id*.
[242] *See* Priv. Ltr. Rul. 200144018 (Nov. 2, 2001).
[243] *Id*. (citing MARY F. RADFORD, GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 991 (Rev. 2d ed. 1983)).
[244] *See* Rev. Rul. 81-264, 191-2 C.B. 185. For a discussion of Revenue Ruling 81-264, see *supra* notes 92-102 and accompanying text.
[245] 387 U.S. 456 (1967).
[246] *See* Van den Wymelenberg v. United States, 397 F. 2d 443, 445 (7th Cir. 1968).

consolidated into the Bosch decisions, the District Director of the Service was provided notice of application but did not appear.[247] The Government argued that a state trial court's adjudication is binding only when the judgment is the result of an adversary proceeding in the state court.[248] The Supreme Court followed *Erie v. Tompkins*[249] in holding that federal authorities must follow the state law as announced by the highest court of the state; however, "Ulf there be no decision by that court then federal authorities must apply what they find to be the state law after giving 'proper regard' to the relevant rulings of other courts of the State.[250]

In *Estate of Kraus v. Commissioner*,[251] the U.S. Court of Appeals for the Seventh Circuit upheld the Tax Court's decision not to respect a state court's reformation of an irrevocable insurance trust; the trial court based its reformation on a scrivener's error. The Seventh Circuit determined that the estate did not show, by clear and convincing evidence, mistake by the Tax Court and held that the Tax Court had given proper regard to the ruling of the state court even though it reached a contrary result.[252]

Some tension exists between the *Bosch* standard and Treasury Regulation section 25.2512-8. *Bosch* requires a state trial court decision to be consistent with the law as expressed by the state's highest court for the decision to bind federal authorities for tax purposes[253] (and for the estate to potentially avoid a taxable gift). Treasury Regulation section 25.2512-8 permits the settlement of a bona fide dispute without tax consequences, even if the settlement is not consistent with state law, as long as it is the product of an arm's length compromise in the ordinary course of business between the litigants.[254] Indeed, the GST regulations also appear to permit a taxpayer to avoid an adverse result through a settlement that is the product of arm's length negotiations if the settlement is within the range of reasonable outcomes had the dispute been litigated to conclusion.[255]

One might reconcile this tension on the basis of the *Van Den Wymelenberg* requirement that federal authorities need not respect a state court decision from a potentially collusive proceeding,[256] which implies that they should respect a decision not from a collusive proceeding. By definition, an arm's length settlement between parties advocating for differing outcomes is not collusive. Thus, if parties dispute the construction of an instrument and advocate for and against the particular construction, the result should not constitute a gift between the parties who settle the case, even if one of the parties determines not to pursue its position based upon a business determination that the risk of litigation is not worth the cost. Perhaps the real distinction is whether or not the particular action involves opposing parties, as opposed to a one-sided action by the taxpayer to unwind a transaction that had an adverse tax result.

Another possibility is to arrange for a determination by the highest court of the state. In *In re Trust D Created Under Last Will and Testament of Darby*,[257] the taxpayer perfected an appeal to the Supreme Court of Kansas by arguing that the Service would not be bound by the lower court's order approving modifications to a trust unless the state's highest court validated it.[258] Unfortunately for the taxpayer, the

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[247] *See Bosch*, 387 U.S. at 465.
[248] *See id*.
[249] U.S. 64 (1938).
[250] *Bosch*, 387 U.S. at 465, 475. See generally Paul L. Caron, *The Role of State Court Decisions In Federal Tax Litigation: Bosch, Erie, and Beyond*, 71 OR. L. REV. 781 (1992).
[251] 875 F. 2d 597 (7th Cir. 1989).
[252] *Id*. at 601.
[253] *See Bosch*, 387 U.S. at 464-65.
[254] *See* Treas. Reg. § 25. 2512-8.
[255] *See id*. § 26. 2601-1(b)(4)(B).
[256] *See* Van Den Wymelenberg v. United States, 397 F. 2d 443, 445 (1968).
[257] 234 P. 3d 793 (Kan. 2010).
[258] *See id*. at 796.

Kansas Supreme Court undid the relief she achieved in the lower court.[259] The beneficiary sought modifications to an irrevocable trust created by her father.[260] The court construed the proposed modifications under the Kansas version of the UTC.[261] Kansas enacted UTC section 411(b) permitting a court to terminate a trust upon the consent of all qualified beneficiaries if the court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust.[262] In addition, Kansas enacted UTC section 412(a) permitting a court to modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination would further the purposes of the trust.[263] To the extent practicable, the court must make the modification in accordance with the settlor's probable intention.[264] Contrary to the UTC, Kansas law presumes that a spendthrift clause constitutes a material purpose.[265] As a result, the court could not modify the trust, which contained a spendthrift clause, to permit an increase in the mandatory distributions that the trust required the trustee to make to the life beneficiary.[266] Nor could the court modify the trust to grant a limited testamentary power of appointment, which the beneficiary alleged would permit the beneficiary's tax benefits to shelter the trust from transfer tax.[267] The court held that a modification to achieve a more favorable tax result is different from a modification to achieve the settlor's probable tax intent.[268] In addition, the proposed changes were in derogation of the interests of the other beneficiaries.[269] Accordingly, the court denied the proposed relief.[270]

In any event, among the completed transaction doctrine, *Bosch*, and Treasury Regulation section 25.2512-8, one has choices as to how to modify an irrevocable trust to avoid adverse gift tax consequences that result from its creation or cause among its beneficiaries.[271]

B. Revenue Ruling 73-142 and the Tax Effect of Prospective Changes

Revenue Ruling 73-142 provides another opportunity to alter the tax consequences of an irrevocable trust, provided the tax consequences one seeks to alter are prospective.[272] In the ruling, the decedent made substantial gifts of property to a trust for his wife and children.[273] "Under the terms of the trust instrument, the decedent reserved the unrestricted power to remove or discharge the trustee at any time and appoint a new trustee, with no express limitation on so appointing himself".[274] The trustee had an unrestricted power to withhold distributions and to apportion income and principal.[275] The state court construed the decedent's power as permitting removal and appointment of a trustee only once and excluding the power to appoint himself trustee.[276] The court's decree was, however, contrary to the decision of the

[259] *See id*. at 804.
[260] *See id*. at 797-98.
[261] *See id*. at 798-99.
[262] *See id*.
[263] *See id*. at 799.
[264] *See id*.
[265] *See id*. at 799-800.
[266] *See id*. at 795.
[267] *See id* at 801.
[268] *See id*. at 801-04.
[269] *See id*. at 801.
[270] *See id* at 804.
[271] *See* Mitchell M. Gans, *Federal Transfer Taxation and the Role of State Law: Does the Marital Deduction Strike the Proper Balance?* 48 EMORY L.J. 871 (1999).
[272] *See* Rev. Rul. 73-142, 1973-1 C.B. 405.
[273] *See id*. at 406. 35414.
[274] *Id*.
[275] *See id*.
[276] *See id*.

highest court of the state.[277] The ruling concludes that *Bosch* does not void a lower court decree that is binding on the parties.[278] Once the time for appeal elapses such that the decree binds the parties, the decree determines the parties' property rights.[279] Accordingly, before the taxing event (the decedent's death), the law of the case cut off the section 2036 and 2038 powers that otherwise might have attracted estate tax.[280] The decree extinguishing the powers would therefore bind the Service, as the decedent clearly lacked the powers after the decree.[281]

Thus, if a modification for the purpose of avoiding tax consequences does not itself have tax consequences—for example, the surrender of a current property interest—a prospective ruling to eliminate a power with future tax consequences appears possible so long as the court decree thereafter binds the taxpayer and cannot be undone.

C. Potential Transfer Tax Consequences of a Trustee's Action to Modify by Decanting or Otherwise

Can the exercise of a trustee's authority under state law or the governing instrument to effect changes to the dispositive provisions of a trust—for example, by a court approved modification, an amendment power, or decanting—have tax consequences to the beneficiaries of the trust? Although perhaps counterintuitive, if state law holds a trustee to a fiduciary standard, such that a beneficiary might object to the exercise of the trustee's discretion, more, not less, tax risk accrues. The result derives from the holding in Revenue Ruling 81-264 that sitting on your state-law rights can have transfer tax consequences.[282] Suppose, for example, that the trustee engages in an exercise of discretion that diminishes a beneficiary's beneficial interest. Can the beneficiary's failure to object constitute a taxable gift? Under the gift tax law, locating the recipient of the gratuitous transfer is only necessary to diminish the property interests of the donor.[283]

The answer to the question may derive in part from the principle that to make a taxable gift, the taxpayer must engage in a voluntary action. The law imposes the gift tax to the transfer of a property interest when the donor relinquishes dominion and control.[284] Treasury Regulation section 25.25 11- 2(a) provides the following:

> The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, . . . is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.[285]

The regulation confirms that, under the gift tax law, locating the recipient of the gratuitous transfer is unnecessary; only diminishing the donor's property interest is necessary. Yet, the regulation also requires

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[277] *See id*.
[278] *See id*. (citing Cornm'r v. Estate of Bosch, 387 U.S. 456 (1967)).
[279] *See id*.
[280] *See id*.
[281] *See id*.
[282] *See* Rev. Rul. 81-264, 1981-2 C.B. 185.
[283] *See generally* Robinette v. Helvering, 318 U.S. 184 (1943).
[284] *See* Estate of DiMarco v. Cornin'r, 87 T.C. 653, 680 (1986), *acq. in result* 1990-2 C.B. 1.
[285] Treas. Reg. § 25. 2511-2(a).

an act of transfer.[286] If the act of transfer is not voluntary, meaning that the beneficiary has no legal ability to object to the transfer, then it seems that the law should not deem the transfer a taxable gift. However, suppose that the beneficiary does have the legal capacity to object. Will the failure to object constitute a taxable gift?

The answer seems to depend on the beneficiary's rights under state law. Suppose one could challenge the trustee's actions only based on a finding of abuse of discretion. *Restatement (Third) of Trusts* provides as follows:

> (1) A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee.
>
> (2) The benefits to which a beneficiary of a discretionary interest is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor's purposes in granting the discretionary power and in creating the trust.[287]

Comment *c* states that

> [i]t is contrary to sound policy, and a contradiction in terms, to permit the settlor to relieve a "trustee" of all accountability. . .[Accordingly,] words such as "absolute" or "unlimited" or "sole and uncontrolled" are not interpreted literally. Even under the broadest grant of fiduciary discretion, a trustee must act honestly and in a state of mind contemplated by the settlor. Thus, the court will not permit the trustee to act in bad faith or for some purpose or motive other than to accomplish the purposes of the discretionary power.[288]

Generally, the court will interpose if the trustee arbitrarily fails to exercise discretion, but *Restatement (Third) of Trusts* acknowledges that a settlor may manifest "an intention to relieve the trustee of normal judicial supervision."[289] In that case, a beneficiary apparently has limited ability to oppose the trustee's exercise of discretion. Additionally, perhaps the failure to oppose the trustee's exercise of discretion would fall within the scope of Treasury Regulation section 25.2512-8.[290] In particular, this would be true if the proceeding would be costly to the beneficiary who believes the likelihood of success to be minimal.

If a trust protector who is expressly not a fiduciary holds the authority to change the trust's terms, fewer tax concerns arise. Trust protectors are permitted by UTC section 808.[291] In that case, the power might appear more akin to a power of appointment, which *Restatement (Third) of Trusts* acknowledges is

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[286] *See id*.
[287] RESTATEMENT (THIRD) OF TRUSTS § 50 (2003).
[288] *Id*. cmt. C.
[289] *Id*.
[290] *See* Treas. Reg. § 25. 2512-8.
[291] *See generally* Richard C. Ausness, The *Role of Trust Protectors in American Trust Law*, 45 REAL PROP. TR. & EST. L.J. 319 (2010).

not subject to fiduciary obligations and which, therefore, presumably cannot be opposed by a disgruntled beneficiary whose interests are diminished.[292]

Although it is unclear whether any fiduciary under a trust instrument can be exonerated from all fiduciary duties, including the duty to act in good faith, certain state statutes permit the appointment of a person able to direct actions of a trustee such that the person giving direction has no fiduciary duties.[293] Therefore, giving a power to appoint property in further trust to a person who is neither a trustee nor a beneficiary would appear to create fewer tax concerns.

More recently, in CCA 202352018, the Service concluded that the modification of a trust by the trustee to include a discretionary tax reimbursement clause in favor of the grantor upon the consent of the beneficiaries constituted a taxable gift by the beneficiaries. The CCA further concludes the tax result would have been the same had the result been accomplished pursuant to a state statute that provided the beneficiaries with a right to notice and a right to object to the modification had the beneficiaries failed to exercise their right to object. The CCA, being the Service's litigation position, also cites to Treasury Regulation section 25.2511-1(e) for the proposition that if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is appliable to the entire value of the property subject to the gift.

The CCA has caused much consternation within the trusts and estate bar, concerns being voiced as to whether every decanting, for example, which under the laws of most states requires notice to the qualified beneficiaries and an opportunity to object, constitutes a taxable gift by each beneficiary who fails to object. The analysis in the prior Revenue Rulings, would seem to mitigate such an extreme result. First, the beneficiary's interest in the trust must be quantified, as even the above-cited regulation requires valuation of "the property subject to the gift". Thus, the beneficiary's property interest must first be determined. And perhaps, the beneficiary would not, in the case of a wholly discretionary interest in a trust, be found, under State law, to have a property interest in the trust estate. In addition, an objection by the beneficiary must have at least some likelihood of success. And a decanting pursuant to express authority granted by state statute would seem unlikely to be susceptible to a successful objection by a disgruntled discretionary beneficiary. Certainly the Service has not suggested that every exercise of discretionary distribution authority by a trustee is susceptible of a taxable gift by the other beneficiaries of the trust. And decanting is merely a subset of that authority.

Accordingly, although we detect the Service's unhappiness with state law, and common law, that make no trust truly irrevocable, the fact is that has always been the case. There is nothing new here, even though perhaps the advent of decanting and non-judicial modification of trusts has heightened awareness. In the CCA, a beneficiary was in effect "added" to the trust. And we assume that such an act could be criticized as a breach of the trustee's duty of loyalty to the existing beneficiary, and thus susceptible of successful objection. That is not actually a new position on the part of the Service. The Service has so ruled in the past, for example, when a trust was modified to permit adopted persons to become additional takers. Therefore, the conclusion in the CCA should be unsurprising, and seen as consistent with prior pronouncements, even if some of the language used may give rise to a concern about possible extensions beyond the facts of the ruling.

The analysis in the CCA may also be implicated if a trustee and/or trust protector propose to toggle off grantor trust status. In case the action is taken by a fiduciary, the fiduciary may be obligated to take only the interests of the beneficiaries into account. It would seem, however, that if the ability to toggle off

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[292] *See* RESTATEMENT (THIRD) OF TRUSTS § 50 Cat. a (2003).
[293] *See* Mary Clarke & Diana S.C. Zeydel, *Directed Trusts: The Statutory Approaches to Authority and Liability*, EST. PLAN., Sept. 2008, at 14.

grantor trust status is expressly conferred in the governing instrument that may be sufficient to exonerate a fiduciary from exercising the authority that is expressly conferred. In order to be able to toggle off grantor trust status by decanting, it seems appropriate to expressly state in the trust instrument that in determining to release the grantor trust powers, the trustee may take the interests of the grantor and the grantor's overall estate planning into account, and may do so notwithstanding any adverse effect on the trust estate or the beneficiaries. Alternatively, the authority to release the grantor trust powers should be held by the grantor and/or a trust protector not acting in a fiduciary capacity.

This leads to the question of when changes to an existing trust under the authority of state common or statutory law will have transfer tax consequences. The answer depends in part on the nature and extent of the property interest held through the trust arrangement and in part on the extent of the beneficiary's legal right to object to the proposed action. The answer might also depend on whether the court construes affirmative consent or the failure to object to the action taken as occurring in the ordinary course of business and thus excepted from the application of gift tax.

D. Clues Under the GST Law

On December 20, 2000, the Treasury Department issued final regulations governing the modification of trusts that are exempt from GST tax under the effective date rules dealing with trusts that were irrevocable on September 25, 1985.[294] The regulations provide guidance on the types of modifications that will not affect the exempt status of a trust. In addition, the regulations clarify the application of the effective date rules to property transferred pursuant to the exercise of a general power of appointment.[295]

Although intended to reduce the number of applications for private letter rulings, taxpayer requests for rulings continue to abound. One reason may be the draconian effect of loss of GST tax exempt status. Although somewhat mitigated under the current rate structure, a flat tax at the highest marginal estate tax rate on each GST is substantial. Another reason may be that the regulations by their terms do not apply to trusts that are GST tax exempt by reason of an allocation of GST exemption,[296] although the Service appears to analyze both cases in the same manner."[297] Taxpayers contemplating changes to a trust that is exempt by reason either of its effective date or of an allocation of GST exemption may be unwilling to assume the risk, and trustees are particularly unlikely to proceed without certainty as to the GST tax effects.[298]

The GST regulations expressly state that GST rules apply only to determine whether a trust that is exempt by reason of its effective date retains its exempt status for GST purposes.[299] The rules do not apply to determine whether a modification results in a gift subject to gift tax, causes the trust to become includible in the gross estate of any beneficiary, or results in the realization of a capital gain for purposes of Code section 1001.[300]

Nevertheless, the GST regulations articulate certain principles that may have general application when analyzing the transfer tax consequences of proposed adjustments to an irrevocable trust after the adjustments take effect.

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[294] *See* Treas. Reg. § 26-2601-1(b).
[295] *See id*. § 26. 2601-1(b)(1)(1).
[296] *See id*.
[297] *See* Priv. Ltr. Rul. 200839025 (May 30, 2008) (rules applicable to a trust exempt by allocation of GST exemption are no less favorable than the rules applicable to a trust exempt by reason of its effective date).
[298] *See* I.R.C. § 2603 (indicating that, in certain circumstances, the trustee may be personally liable for the GST tax).
[299] *See* Treas. Reg. § 26-2601-1(b)(4)(i).
[300] *See id*.

Treasury Regulation section 26.2601- 1(b)(4)(i)(A) provides as follows:

> The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13 if . . . (1) [e]ither . . . (i) [t]he terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or (ii) [a]t 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 or approval of any beneficiary or court; and (2) [t]he terms of the governing instrument 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. . . . [An] exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not [violate the foregoing rule].[301]

The two rules together constitute the so-called GST rule against perpetuities.

The GST rule against perpetuities indicates that proceeding under authority contained in the governing trust agreement ought not to have tax consequences, provided the duration of the trust does not extend beyond the common law rule against perpetuities.[302] One should note that the need for beneficiary consent or court intervention falls outside the exception.[303] A voluntary application to court, by itself, would seem to not have adverse tax consequences.[304] But if the law requires court approval or beneficiary consent, then the power of distribution would fall outside the safe harbor of the regulation.[305]

In Private Letter Ruling 200228007, the decedent created a separate testamentary trust for each of three children.[306] The trust for Child 3 required the payment of income quarterly to Child 3 for life. The decedent's will appointed Child 1 and Child 2 as trustees with the power to make any distribution of trust principal as they thought proper and necessary for the comfort of Child 3 and her children. Upon the death of Child 3, the trust fund would pass on to her children in further trust until the trustees thought it proper to pay the trust fund to the children. Applicable state law permitted the trustees to petition for modification or termination of a trust. The state court determined that the document's reference to children referred only to natural, not adopted, children. Child 3 was seventy-three years old and the court determined that the two children of Child 3 had a vested remainder interest in the trust. The state court approved a modification terminating the trust in favor of a new trust with Child 3 as sole trustee. The new trust limited the trustee's power to distribute principal to herself to an ascertainable standard under state law. Upon Child 3's death,

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[301] *Id*. § 26.2601-1(b)(4)(i)(A).
[302] *See id*. § 26. 2601-1(b)(4)(i)(A).
[303] *See id*.
[304] *See id*.
[305] *See id*.
[306] *See* Priv. Ltr. Rul. 200228007 (Apr. 3, 2002).

the new trust also required equal distribution of the assets to her children or their respective estates. The Service ruled that the modification was within the original trust instrument's authority and, therefore, did not constitute an exchange under section 1001.[307] The Service further ruled that the modification would not cause the old trust or the new trust to lose its exempt status for purposes of chapter 13.[308] Finally, the Service ruled that none of the beneficiaries had made gifts and that the new trust would not be included in Child 3's gross estate because the distribution power was not a general power of appointment.[309]

Note that state property law determined that the grandchildren's interests vested.[310] Even though the modification reduced the standard of distribution to Child 3, the Service did not find that Child 3 had made a gift to the remainder beneficiaries.[311] This is interesting as the Service is presently unwilling to rule on the gift tax consequences of the surrender of a property interest in a discretionary trust because the value of the property interest surrendered is a question of fact.[312] Here, Child 3 would appear to have reduced the future opportunity to receive trust distributions by becoming a trustee, with the effect that future distributions would be limited to an ascertainable standard.[313] Yet, because that result derived from state law governing the trust since its inception,[314] perhaps the Service considered the reduction involuntary and thus without gift tax consequences. The distinction seems somewhat of a fine line; becoming trustee was voluntary, but the reduction in the standard of distribution that resulted was not.[315]

A separate rule deals with distributions by the exercise of a power of appointment. The exercise, release, or lapse of a power of appointment—other than a general power of appointment within the meaning of section 2041(b)—will not have adverse GST consequences if the original trust contained the power, and the holder does not exercise it in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period beyond the GST rule against perpetuities.[316] No other restriction apparently applies. Accordingly, the GST rules appear to confirm that, if exercised within its scope, a power of appointment or a power construed as akin to a power of appointment—which construction would appear to mean a power not controlled by any fiduciary obligations under *Restatement (Third) of Property*[317] —does not create transfer tax risk because the beneficiaries have no means to object to its effective exercise.[318]

A modification that resolves a bona fide dispute may also avoid adverse tax consequences. Treasury Regulation section 26.2601-1(b)(4)(i)(B) provides the following:

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[307] *See id*.
[308] *See id*.
[309] *See id*.; cf. Priv. Ltr, Rul. 200917004 (Apr. 24, 2009) (ruling that modification to a trust agreement to include legally adopted infants or minor children in the definition of the terms *issue* and *descendants* had no GST consequences because no shift to lower generations occurred, but did have gift tax consequences to those whose' interests were reduced).
[310] *See* Priv. Ltr. Rul. 2002280007 (Apr. 3, 2002).
[311] *See id*.
[312] *See* Priv. Ltr. Rul. 200243026 (Oct. 25, 2002).
[313] *See* Priv. Ltr. Rul. 2002280007 (Apr. 3, 2002).
[314] *See id*.
[315] *Cf*. Priv. Ltr. Rid. 200839025 (May 30, 2008) (holding a change of the standard of distribution to one of absolute discretion without limit to be an "increase" in the distributions to non-skip persons and thus not a shift of beneficial interests to a lower generation). Accordingly, a shift to an ascertainable standard might be considered a "decrease" depending on the circumstances.
[316] *See* Estate of Timkin v. United States, 630 F. Supp. 2d 823, 834 (N.D. Ohio 2009) (explaining lapse of a general power of appointment is a constructive addition); Estate of Gerson v. Comm' r, 507 F. 3d 435, 440 (6th Cir. 2007) (noting grandmother exercised her general power of appointment in favor of grandchildren).
[317] RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 cmt. g (2011).
[318] *See* Treas. Reg. § 26. 2601-1(b)(4)(i)(A).

> 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 the provisions of chapter 13, if ... (1) [t]he settlement is the product of arm's length negotiations; and (2) [t]he 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.[319]

In Private Letter Ruling 200209007, the Service considered the modification of a testamentary trust that owned a concentration of decedent's low-yield, closely held stock.[320] The trust instrument authorized retention of investments not otherwise authorized by statute so long as the trustee deemed advisable, and the instrument directed that, if possible, the trustee hold the stock until termination of the trust[321] All the trust's income beneficiaries had died except one who was entitled to a share of the income for life.[322] Upon the death of the surviving income beneficiary, the trustee was to divide the trust into shares for the descendants of four of the deceased income beneficiaries.[323] The surviving income beneficiary and several contingent remaindermen brought suit against the trustee to modify the trust under state law permitting modification of a trust "if the court finds that the modification will neither materially impair the accomplishment of the trust purposes nor adversely affect the interests of any beneficiary, or if made, materially benefit the trust or any beneficiary."[324] The parties sought commutation of the income beneficiary's life interest.[325] Subsequently, the state enacted a statute authorizing a trustee to make adjustments between principal and in-come under a prudent investor standard.[326] The income beneficiary amended its pleadings to allege "that the [t]rustee failed to invest [t]rust assets in a manner consistent with his interest as a life tenant and to apportion [t]rust receipts and expenses between income and principal in the manner required by law."[327] The contingent remaindermen opposed the requested relief.[328]

In settlement of the dispute, the parties entered into a modification agreement whereby (1) the income beneficiary's interest would be commuted for a fair price, (2) the balance of the trust would be divided into two trusts, one to distribute income to the presumptive remaindermen, determined as of each quarterly distribution, and the other to accumulate income, and (3) the contingent remaindermen who would not receive income distributions would receive a make-up distribution upon the death of the former income beneficiary.[329] The court appointed a special master who found that the modification would not materially impair accomplishment of the trust's purposes.[330] The special master also found it unlikely that the testator anticipated the deaths of five of the six income beneficiaries and the resulting accumulation of a large portion of the trust income over more than forty-one years.[331]

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[319] *Id*. § 26.201-1(b)(4)(i)(B)
[320] *See* Priv. Ltr. Rul. 200209007 (Mar. 1, 2002).
[321] *See id*. at 5.
[322] *See id*.
[323] *See id*. at 5-6.
[324] *Id*. at 6.
[325] *See id*.
[326] *See id*.
[327] *Id*.
[328] *See id*.
[329] *See id*. at 7.
[330] *See id*. at 8.
[331] *See id*. at 9.

The Service opined that no gift tax consequences would result from a settlement based on a compromise of valid claims that reaches an economically fair result.[332] If the settlement differs from the result under state law because of competing claims, then courts must "consider whether the difference may be justified because of the uncertainty of the result if the question were litigated."[333] The Service found that the modification agreement provided a result "within the range of reasonable settlements" based on the expert opinions and the findings of the special master and of the court.[334] Accordingly, the Service ruled that the settlement created no gift tax consequences.[335]

The Service also ruled that the new trusts created by the modification agreement would continue to be exempt from GST tax because the modifications did not shift any beneficial interest to a beneficiary in a lower generation.[336]

This ruling leaves open the question of whether the taxpayer needs to satisfy both the settlement test and the "no shifting" test to avoid loss of exempt status. The regulations do not require one to satisfy both. However, if one changes the beneficiaries' interests in a manner that is tantamount to a modification because no reasonable interpretation of the governing instrument would yield the settlement result, then one must satisfy both tests. In that case, the importance of the bona fide settlement test has less to do with avoiding loss of GST exemption than it does with avoiding taxable gifts or sales or exchanges of beneficial interests that have potential income tax consequences than avoiding loss of GST exemption.

Nevertheless, the GST rule on settlements appears to be somewhat in conflict with the Bosch standard, which requires that a state court's holding be consistent with the law of the state as articulated by its highest court.[337] Perhaps what we are seeing is an unarticulated application of Treasury Regulation section 25.2512-8. If the parties to a bona fide dispute determine to settle their differences by compromising their legal positions, it seems that the law construes this as a valid business decision, not as a taxable gift resulting from a voluntary transfer.[338]

Although expressly limited to the GST effects, the GST regulations appear to provide a framework within which to analyze the tax consequences of modifications of trusts after the modifications take effect. The same general principles emerge. Authorities generally ought to respect changes permitted under the governing instrument or applicable state law. Changes to settle a bona fide dispute, even changes failing the *Bosch* standard, also may avoid transfer tax consequences to the extent the result is a reasonable compromise of the competing interests. One must carefully analyze any other changes, such as changes the interested parties agree to, to determine if the changes shift beneficial interests among the parties.

V. Making Changes by Substitutions or Granting Powers over Trusts

A. Exercise of a Substitution Power

Many irrevocable trusts are so-called "grantor trusts" for Federal income tax purposes under subpart E of part 1 of subchapter J of chapter 1 of the Code. The advantage of a grantor trust is that the grantor retains the privilege of paying income tax on property that is not owned by the grantor for transfer tax purposes, thus permitting the grantor trust to enjoy income tax free growth. In Revenue Ruling 2004-

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[332] *See id*. at 10.
[333] *Id*.
[334] *Id*.
[335] *See id*. at 10-11.
[336] *See id*. at 11-12.
[337] *See* Comm'r v. Estate of Bosch, 387 U.S. 456, 465 (1967).
[338] *See* Harris v. Comm'r, 340 U.S. 106, 109 (1950).

64,[339] the IRS confirmed that the payment of income taxes by the grantor with respect to a grantor trust does not cause the grantor to make a taxable gift to the trust. Frequently, one of the powers retained by a grantor to cause a trust to be taxed to the grantor is a power of substitution under section 675(4)(C) of the Code. Under section 675(4)(C), the power exercisable in a non-fiduciary capacity without the approval or consent of a person in a fiduciary capacity to "reacquire the trust corpus by substituting other property of an equivalent value" causes a trust to be taxable to the grantor. Two potential problems arise:

1. Is the power really held in a non-fiduciary capacity?

2. Does the existence of the power held in a non-fiduciary capacity create estate tax inclusion concerns?

In PLR 200603040 (not precedent) and PLR 200606006 (not precedent), IRS refused to rule favorably on the estate tax inclusion issues under sections 2033, 2036, 2038 and 2039 without a representation that the power was held in a fiduciary capacity.

In *Estate of King v. Commissioner*, [340] the decedent was in the professional banking business and retained investment control over the trust estate. Each trust provided for income to child for life and remainder to child's issue, *per stirpes*. The government argued sections 2036(a)(2) and 2038 alleging that the grantor could increase the interests of the life income beneficiaries to the detriment of the remainder beneficiaries, the grantor could dispose of the assets for little or no consideration, and the grantor had an unlimited right to substitute assets of unequal value. The court held the grantor was constrained by New York law, and his actions were subject to the review of a court in equity. Therefore, the grantor was in effect a fiduciary and was not at liberty to administer the trust for his own benefit or to ignore the rights of the beneficiaries, even though he no doubt would be permitted wide latitude in the exercise of this discretion as to the types of investments to be made. Accordingly, there was no estate tax inclusion.

Estate of Jordahl v. Commissioner,[341] is to the same effect. *Jordahl* concerned a life insurance trust over which decedent retained a power of substitution not only as to the policies but also as to the securities and other property in the trust. The court held that substitutions of property of equal value could not result in shifts of beneficial interests because the powers would have to be exercised in good faith in accordance with fiduciary responsibility. The court concluded the substitution power was equivalent to a power to direct investments. The court did hold that the power to substitute policies is not an incident of ownership under section 2042 because the requirement of equal value would seem to demand equal cash surrender and face value, comparable premiums and a similar form of policy.

What then are the limits on a substitution power? Can you substitute high income assets for low income assets with an equal fair market value? It seems that you can substitute one publicly traded stock for another.

These issues were addressed in Revenue Ruling 2008-22 [342]. The Ruling deals only with section 2036 and section 2038. It may not deal with section 2036(b), although a representative from the Treasury Department have indicated that the reference to section 2036 was intended to include all of section 2036. The Ruling did not deal with section 2042. The Ruling provides guidance on whether the corpus of an *inter vivos* trust is includible in the grantor's gross estate under section 2036 or 2038 if the grantor retained the power, exercisable in a non-fiduciary capacity, to acquire property held in trust by substituting other

[339] 2004-2 C.B. 7 (2004).
[340] 37 T.C. 973 (1962).
[341] 65 T.C. 92 (1975).
[342] 2008-16 I.R.B. 796.

property of equivalent value. The Ruling holds that a substitution power will not, by itself, cause the value of the trust corpus to be includible in grantor's gross estate if the trustee has a fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of the power by satisfying itself that:

1. The properties acquired and substituted are in fact of equivalent value; and

2. The substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

Revenue Ruling 2008-22 sets forth the following facts:

1. Trust for D's descendants.

2. D is prohibited from serving as trustee.

3. D must certify in writing that the substituted property and the trust property are of equivalent value.

4. The trustee has a duty of impartiality in investing and managing trust assets.

5. Local law, without restriction in the trust instrument, confers on trustee power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition and manage the trust property.

The Ruling also holds that the trustee's fiduciary obligation to ensure grantor's compliance with the terms of the power may be under local law or the trust instrument. The trustee has a duty to "prevent" the exercise of the power if assets being substituted have a lesser value. Therefore, D cannot exercise power in a manner that would reduce the value of the trust corpus. Duty of impartiality requires T to prevent shifting of benefits between or among the beneficiaries. Either trustee has duty of impartiality and can reinvest, or the nature of trust investments or level of income does not impact the respective interests of the trust beneficiaries, such as when the trust is administered as a unitrust or when distributions from the trust are limited to discretionary distributions of principal and income.

Revenue Ruling 2011-28,[343] extends Rev. Rul. 2008-22 to a life insurance policy. The ruling provides guidance regarding whether a grantor's retention of a power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held by the trust by substituting other assets of equivalent value will cause the value of the insurance policy to be includible in the grantor's gross estate under section 2042 of the Code. The ruling provides that a grantor's retention of the power will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under section 2042, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries.

PLR 201235006 (not precedent) analyzes a life insurance trust created for the primary benefit of taxpayer which was not a grantor trust. Taxpayer formed a new trust which granted the taxpayer a power of substitution. The proposal was to sell the policy from the first trust to the second trust. IRS ruled favorably that the exception to the transfer for value rules for a transfer to the grantor under section 101 applies, and the policy sale will not be treated as a transfer for value (which would otherwise cause a

[343] I.R.B. 2011-49 (12/5/2011).

substantial portion of the policy proceeds to become subject to income tax) and that the policy would not become subject to inclusion in the taxpayers gross estate under section 2042(2) (incidents of ownership) or sections 2033, 2036 or 2038. The ruling also confirms that the application of section 675(4) trumps the application of section 678 with respect to the powers of withdrawal held by the beneficiaries in the second trust.

Therefore, by navigating the above requirements, a grantor could retrieve assets from a grantor trust by substituting assets of an equivalent value.

What if the grantor tenders property in substitution for assets of the trust estate and the trustee refused to honor the substitution? In *Manatt v. Manatt*,[344] the grantor retained a power of substitution in a non-fiduciary capacity within the meaning of Rev. Rul. 2008-22. The trustee resisted the substitution arguing that the trustee has a fiduciary duty to ensure compliance with the power of substitution, namely that the property substituted be of equivalent value. The grantor proposed to substitute cash for closely held stock owned by the trust. The court granted summary judgment in favor of the grantor, focusing, in particular, on the language of the substitution clause:

> . . . Neither the consent of the trustee nor the consent of any other person shall be required. . . . In all events, the trustee shall satisfy himself or herself that the properties acquired and substituted pursuant to this paragraph are, in fact, of equivalent value; . . . .

The court concluded that because the power of the trustee to ensure equivalent value was written in the past tense, the trustee could not block the substitution, but could merely verify the values after the fact, and if necessary, demand additional property from the grantor. The court held that the trustee has the fiduciary duty to determine whether the substitution was of equivalent value but could not abridge, delay or block the grantor from exercising the power of substitution.

The court cited favorably *Benson v. Rosenthal*[345] in which the grantor was permitted to substitute property of the trust for promissory notes and distinguished *In re Dino Rigoni Intentional Grantor Trust for the Benefit of Christopher Rajzer*[346] where the substitution language did not express the trustee's authority in the past tense.

B. Retrieving Assets with a Sale

An irrevocable grantor trust may have previously engaged in a transaction with its grantor, such as an installment sale. If the transaction remains open, the trustee could transfer the assets purchased back to the grantor in satisfaction of the promissory note. For example, if the note were due, the grantor could refuse to refinance and instead demand repayment. Alternatively, the trustee could effectuate the sale supported by appropriate appraisals. Assuming the transaction is for full and adequate consideration, it would not seem that the beneficiaries could challenge it, for the reasons discussed above with respect to substitutions.

Note that if the trust is not already a grantor trust, perhaps the acquisition of the assets by the grantor would make it one, thus avoiding income tax on the transaction. Rev. Rul. 85-13,[347] appears to stand for the proposition that transactions between a grantor and her grantor trust are ignored for income tax purposes. But it also states that if the grantor purchases all the assets of her trust for a note, the trust becomes a grantor

[344] 2018 WL 3154461 (S.D. Iowa, Central Division 2018).
[345] Civil Action No. 15-782, 2016 WL 2855456 (E.D. LA May 16, 2016).
[346] No. 321589, 2015 WL 4255417 (Mich. Ct. App. July 14, 2015).
[347] 1985-1 C.B. 184. *See* CCA 201343021 discussing the breadth with which Rev. Rul. 85-13 should be interpreted, as well as certain adverse case law and rulings.

trust simultaneously, and there is no gain recognition as a result of the purchase itself. The facts of Rev. Rul. 85-13 involved an unsecured promissory note with adequate interest. The IRS appears to view the transaction as an indirect borrowing.

Be aware that *Rothstein v. U.S.,*[348] is to the contrary. The court held that the transaction constituted an indirect borrowing and caused the trust to become a grantor trust, BUT the transaction itself resulted in gain recognition. But, until revoked, the IRS is obligated to follow its own published ruling.[349]

C. Granting Powers over a Trust to a Beneficiary

If the transfer tax effects of an irrevocable trust are not beneficial, it may be possible to cause a trust to be included in the gross estate of a beneficiary by granting a beneficiary a general power of appointment within the meaning of section 2041 of the Code. As discussed above, a decanting power is generally interpreted to include the power to grant powers of appointment to the beneficiaries in whose favor a trust may be decanted. The Uniform Trust Decanting Act and many state decanting statutes expressly permit a trustee with unlimited discretion to make distributions to a beneficiary to exercise decanting authority to distribute the trust estate to a new trust that would confer on the beneficiary a general power of appointment. Doing so could permit the beneficiary to use the beneficiary's gift, estate and generation-skipping transfer tax exemptions to shield the trust from transfer tax. If the property were included in the beneficiary's gross estate, the trust estate would achieve a basis adjustment under section 1014.

D. Granting Powers over a Trust to the Grantor

A major impediment of returning the gifted property to the grantor may be the inability to "undo" the gift for later gift and estate tax purposes. First, it does not seem a grantor's gift tax exemption is not restored during lifetime if the gifted property becomes estate tax includible.[350] Thus, if the property previously transferred becomes included in the donor's gross estate, the original taxable gift is not ignored in computing gift tax on subsequent taxable gifts. Thus, during lifetime, the gift tax shelter used on previously gifted property is not "restored" even if the property is returned to the donor or becomes includible in the donor's gross estate.[351]

However, for estate tax purposes, the estate tax is based upon the sum of the taxable estate and adjusted taxable gifts (essentially all taxable gifts made after 1976). However, a transfer is not considered an adjusted taxable gift (in other word, it is expunged for purposes of computing the estate tax) if the gift is includible in the gross estate.[352] Nonetheless, it seems that this exclusion from adjusted taxable gifts only applies to gifts that are included in the gross estate by one of the so-called "string" provisions of the Code, such as sections 2035, 2036, 2037, 2038 and possibly section 2042[353]. For example, it the taxpayer has

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[348] 735 F.2d 704 (2nd Cir. 1984).

[349] *See* Rauenhorst v. Comm'r, 119 T.C. 157 (2002).

[350] At one time, there were graduated gift tax rates—now essentially, there is a 40% flat rate. One effect under prior law as that each prior taxable gift "pushed" any later taxable gift into a high bracket or brackets until the top bracket was reached.

[351] Only completed gifts constitute taxable gifts and it is only taxable gift that are used to determine gift tax on later taxable gifts. See "Complete and Incomplete Gifts. The [Internal Revenue] Code states that if a donor 'transfers property by gift,' such donor will be liable for a gift tax. However, not all transfers of property are considered 'gifts' or, more appropriately, 'completed gifts.' This is important because only completed gifts are taxable gifts." The ElderLaw Portfolio Series, Margolis (Editor), (Aspen Publications 2007), sec. 4-4.

[352] Section 2001(b).

[353] Under Section 2042, proceeds paid on death are included in the gross estate of the insured if they are paid to or for the benefit of the estate of the insured or the insured holds any incident of ownership in the policy at death. It does

made a taxable gift in trust for a single beneficiary, and retains the power to determine when that beneficiary will receive distributions from the trust, the gift will be complete and subject to gift tax. Yet the property will be included in the donor's gross estate at death under section 2036 and 2038(if the power is held at that time or released within three years of death) and, if so, the taxable gift made should not be considered an adjusted taxable gift in computing the estate tax.[354]

Suppose a donor creates a self-settled trust in a jurisdiction where the transferred property is not subject to the claims of her creditors.[355] This should mean that the transfer to the trust is a completed gift for gift tax purposes and would not otherwise be included in the grantor's gross estate for estate tax purposes.[356] If the trustee makes a distribution of property to the grantor, the adjusted taxable gift likely is not eliminated when computing the grantor's estate tax. On the other hand, if the property is transferred to a another self-settled trust and applicable local law allows the creditors of the transferor to attach the trust property, then estate tax inclusion will occur at the grantor's death and the adjusted taxable gift should be eliminated.[357]

Unless the trust was established as a self-settled asset protection trust, returning assets to the grantor by a distribution from the trust to achieve estate tax inclusion, and a basis adjustment, may be more challenging from a fiduciary perspective. As discussed above, the IRS has expressed concern about reintroducing a grantor into an irrevocable trust, where the grantor was not an existing beneficiary, as having gift tax consequences to the beneficiaries of the trust. However, it may be possible to give the grantor a power over the trust that causes estate tax inclusion. Although section 2036 generally requires the grantor to have retained the right to enjoy the income from a trust or to determine the enjoyment of the income from a trust to cause estate tax inclusion, section 2038 does not require the power to alter, amend, terminate or revoke a trust to have been retained at the time of the transfer. Instead, such a power arising after the fact would cause estate tax inclusion.

Of course many irrevocable trusts are expressly drafted to prevent a grantor from having powers over the trust that would cause estate tax inclusion. But perhaps those prohibitions could be eliminated by decanting. Section 2038 applies even if the power to control arises later, unless the control is the result of another, essentially "an unrelated transaction."[358] For example, it appears that if the taxpayer transferred property in trust under the protection of her gift tax exemption and allocated GST exemption to the transfer in a transaction that was a completed gift, later giving the grantor a power of control (e.g., a power to determine the timing of when a beneficiary would receive a distribution) would cause estate tax inclusion. Yet, the trust may remain GST exempt, even though the property will be included in the grantor's estate

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not seem that the mere retention of some incident of ownership (e.g., ability to borrow from the policy's cash value) renders the gift of the policy incomplete for Federal gift tax purposes (see Treas. Reg. 25.2511-2) but the retained incident of ownership would seem to result in the proceeds being included in the insured's gross estate if held at death. Note that the gift would be of the policy but the estate tax would apply to the proceeds paid upon death. Therefore, it is at least arguable that the "gift" (of the policy) is not included in the donor's estate thereby preventing the taxable gift of the policy from being an excluded as an adjusted taxable gift for purpose of calculating estate tax under Section 2001(b).

[354] See Treas. Reg. 25.2511-2(d) (gift not rendered incomplete by retaining the power to determine the timing of receipt of the property) and Treas. Reg. 20.2038-1(a)(third to last and second to last sentences) (retention of the power to determine the timing of the recipient of the property causes estate tax inclusion).

[355] Cf. Rev. Rul. 76-103, supra.

[356] PLR 200937007 (not precedent) and PLR 200944002 (not precedent).

[357] Rev. Rul. 76-103, supra; Rev. Rul. 77-378, 1977-2 CB 347; Paxson v. Commissioner, 86 TC 785 (1986).

[358] See Rev. Rul. 84-179, 1985-2 CB 195.

under section 2038 as nothing would appear to undo the effective allocation of GST exemption.[359] And the prior taxable gift should not be treated as an adjusted taxable gift, thus avoiding double taxation.

E. Use of Joint Trusts and Marital Trusts

Several private letter rulings (not precedent) have considered the use of a joint trust for a couple in a non-community property state which confers on the first spouse to die a general power of appointment with the goal of achieving a basis adjustment in the assets on the death of the first spouse to die.[360] A variety of issues are raised by the strategy. One issue is whether a gift tax marital deduction is available to the donor who grants the spouse such a power. The second issue is whether the disposition of the property included in the estate of the first spouse to die is denied a basis adjustment by reason of section 1014(e) which provides that property transferred to a decedent within one year of death that is retransferred to the donor (or the donor's spouse) has an adjusted basis equal to the adjusted basis immediately prior to the decedent's death. It may be possible to structure the disposition so as to avoid the application of section 1014(e) but the donor will not have the same control and interest in the property as before.

A "Section 2038 Marital Trust" discussed by Steven Akers and Steven Baxley in the Bessemer Trust Tax Insights entitled "2025 Tax Law Changes: Key Takeaways for High-Income Taxpayer" is another strategy designed to achieve a basis adjustment on the death of the first spouse to die. For example, the first spouse would create an irrevocable trust for the second spouse as a discretionary beneficiary and provide that on the second spouse's death the assets pass to the second spouse's estate. The first spouse retains the right to terminate the trust prior to the death of the second spouse and cause the assets to be paid to the second spouse. The foregoing power would cause estate tax inclusion in the estate of the first spouse under section 2038. On the other hand, if the second spouse dies first, the assets would pass to the second spouse's estate, causing estate tax inclusion in the estate of the second spouse. Because the first spouse's only power would be to accelerate the distribution to the second spouse, as previously discussed, the gift to the trust would be a completed gift, but would qualify for a marital deduction as an estate trust.

F. Moving Assets Upstream

Another suggestion attributed to Mickey Davis and Melissa Willms[361] is to potentially grant a person in a higher generation a testamentary general power of appointment (perhaps by formula to limit the power to the grantee's unused estate tax shelter and GST tax exemption) in order to include the trust estate in the grantee's gross estate for estate tax purposes. The donor may make a taxable gift to the trust, but could also increase the assets of the trust estate by selling assets to the trust. The general power of appointment (even if its exercise requires the consent of an independent party) would cause the assets of trust to be included in the gross estate of the grantee under section 2014, and the assets would therefore receive a basis adjustment to fair market value at the grantee's death under section 1014(b)(9), even if the grantee does not exercise the general power, and even if the assets are leveraged. At the same time, if the grantee does not exercise the power of appointment, similar to a so-called "Supercharged Credit Shelter Trust[SM]"[362] the trust would remain a grantor trust as to the original donor.[363] If the trust were settled in a jurisdiction that does not allow the donor's creditors to reach the trust, the donor could become a

[359] To avoid reducing the trust estate by estate tax, the taxpayer could allocate the estate tax to other assets includible in the grantor's gross estate.
[360] *See, e.g.*, PLR 200101021 (not precedent).
[361] Davis & Willms, *All About That Basis: How Income Taxes Have Reshaped Estate Planning,* ALI-CLE Planning Techniques for Large Estates (April 2018).
[362] An idea conceived by Mitchell M. Gans and Jonathan G. Blattmachr and discussed in a number of articles by them.
[363] Regs §1.671-2(e)(5) (a transfer from one trust to another does not change the identity of the grantor, but the exercise of a general power of appointment over the transferor trust causes the grantee to become the grantor of the transferee trust).

discretionary beneficiary of the trust follow the death of the grantee. In addition, the donor could continue to engage in estate planning transactions with the trust without income tax friction because the trust could continue as a grantor trust with respect to the donor assuming the trust has provisions, such as a substitution power, causing it to be a grantor trust.

VI. Modifications Using Trust Protector Powers

Another method whereby an irrevocable trust may be modified is by conferring express authority to modify the trust instrument upon either a trustee or a trust protector. The use of trust protector powers has become more widespread. And it seems that courts are inclined to respect a trust protector's exercise of express authority conferred by the governing instrument, regardless of how dramatic the consequences of that exercise may be on the outcome of a pending litigation.

In *Devitt v. Wellin*,[364] the trustee of an irrevocable family trust brought an action in state court against the beneficiaries of the trust challenging the beneficiaries' alleged liquidation of a limited partnership. The Trust Protector appointed by the settlor exercised his authority to modify the governing instrument of the trust to change the procedure for removal of a trust protector. The court construed (i) a general provision permitting amendments to the manner in which beneficiaries would benefit from the trust and to the administrative provisions of the trust and (ii) a provision permitting trust protectors irrevocably to release, renounce, suspend or modify to a lesser extent any and all powers and discretions. The court found that the two provisions do not conflict and the trust protector is not limited to modifying the administrative provisions to reduce or limit the trust protector's authority. Accordingly, the court held that the Trust Protector acted within his authority to modify the removal provisions, and because the children did not comply with the requirements, (1) the Trust Protector was not validly removed, (2) the successor trustee appointed by the trust protector appointed by the children was not validly in office, and (3) the original trustee remained in office with standing to sue the children, as co-trustees, for their actions in connection with the family partnership.

In *Minassian v. Rachins*,[365] the children of a trust's settlor brought an action against the settlor's wife, who was the beneficiary and trustee of the trust, claiming breach of fiduciary duty. The settlor's wife appointed a trust protector who, pursuant to express authority in the governing instrument, amended the trust instrument. The children challenged the validity of the amendments made by the trust protector. The children argued unsuccessfully that FTC sections 736.0410-736.04115 and 736.0412 provide the exclusive means for modifying a trust under the FTC. A similar argument was made without success by the trustee in *Peck* described above. The court finds that Section 736.0808(3) establishes a valid method to appoint a trust protector with the authority to modify or terminate the trust. Finding that the trust contained an ambiguity, the court upheld the amendment made by the trust protector which established multiple trusts upon the death of the settlor's wife for the benefit of the children. Remarkably, the court appears to conclude that the administration of the trust for the wife, which after the amendment would terminate at her death in favor of new trusts for the children, could not be challenged by the children. Thus, we find that the amendment provisions granted to the trust protector, as in *Wellin*, actually change the course of the pending litigation against the trustee. One can imagine such provisions working just as well as an *in terrorem* clause should the trust protector be granted amendment powers that can alter beneficial interests as well as make administrative changes.

[364] 2015 WL 566486 (USDA So. Car. 2015).
[365] 152 So.3d 719 (4th DCA 2014).

VII. Conclusion

Rescissions, reformations, modifications, and terminations, however desirable, initially require analysis to determine the potential for adverse tax effects. Beneficial interests in trust constitute property rights under state law susceptible of gratuitous transfer with potential transfer tax consequences. Although the valuation of those rights may vary from rights that one can actuarially determine with fair certainty to rights with arguably nominal value, alterations to those rights will not escape transfer tax scrutiny. The law has developed to permit rescission of a transaction with adverse tax effects if a mistake of fact or law causes unanticipated consequences. This analysis is perhaps distinguishable from other attempts to modify a trust after creation because the availability of a remedy under state law permits one to construe the transfer as incomplete for transfer tax purposes.

In the absence of a mistake of fact or law, the analysis becomes more complex. The outcome depends on the remedy sought and the property interests of the parties prior to and after implementation of the relief. To the extent the authority to implement changes emanates from the governing instrument or from state law in effect at the time the trust became irrevocable, the primary concern will be whether the beneficiary has grounds to object and the likelihood of success in asserting the objection. If the person with authority to effectuate a change has fiduciary duties, the potential for transfer tax consequences may increase. Nevertheless, a trustee with absolute discretion will be far less susceptible to successful criticism than one with more limited authority. And defending a modification—even one achieved by consent—as being in the ordinary course of business seems possible, depending on the facts.

With the increase in available transfer tax exemptions, clients may no longer need the irrevocable trusts they have created to save transfer taxes. In addition, those trusts may create a lost opportunity for a basis adjustment in the assets at the death of the settlor. Various strategies to retrieve the assets or cause estate tax inclusion without the payment of estate taxes may mitigate the results. Planning for those possibilities at the drafting stage will enhance their effectiveness.

As the tax law continues to propel the trend towards longer duration trusts and as state law provides greater opportunities to amend the terms of irrevocable trusts after creation to balance the interests and avoid excessive “dead hand” control, lawyers will need to take greater care to stay out of the danger zone.