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Five Easy Pieces:

Fixing or Redesigning Irrevocable Plans

Clients often consult us about the terms of older trusts or other arrangements that may have been put in place by a spouse, parents or grandparents at a time when the factual circumstances or family objectives were different. Even the terms of a trust created by the client just a few years ago may not be optimal due to a change in the applicable Federal or State tax rules. Typically, the arrangement is irrevocable, as it would need to be in order to achieve tax benefits. Clients ask if we can correct or at least improve an otherwise irrevocable, but no longer suitable, facet of an estate plan. Can we do it in a way that is legally effective, tax-efficient and emotionally satisfying for the client?

Depending on the circumstances, a number of easy fixes may be appropriate:

1. **Exercising Discretionary Powers.** Many trusts are discretionary, giving the Trustee an unlimited authority to pay out principal and income. Sometimes the solution can be as simple as asking the Trustee to distribute principal to a beneficiary so that it can be used more advantageously. Some examples:
 - To allow a beneficiary to engage in planning for his or her own family;
 - To intentionally include an asset in a beneficiary's gross estate to achieve a step-up in basis;
 - To create a longer-term "dynasty" family trust;
 - To fund a business that would not otherwise be a suitable trust investment;
 - To allow a beneficiary to leverage the use of his/her exemption prior to 2026 when the Federal exemption is scheduled to be reduced.

2. **Statutory Revocation.** Many states have statutes that permit an irrevocable trust to be revoked or amended with the consent of the creator of the trust and the interested parties. In New York, the statute is EPTL 7-1.9. When the creator is alive and the parties agree, this can be a very straightforward do-over.
3. **Decanting.** If Trustees have sufficient discretion, they may be able to take an existing irrevocable trust and pour it into a newly created trust that is better designed to satisfy current objectives. In New York, the statute is EPTL 10-6.6. The degree of discretion granted to the Trustee in the original trust instrument will affect the ability of the Trustee to include or exclude original beneficiaries. Even if a statute is not available in the particular jurisdiction, common law decanting may be an option.
4. **Unitrust and Power to Adjust.** When the beneficiary's cash flow is an issue, or the remaindermen are concerned with long-term investment decisions, one solution that can satisfy everyone may be to simply ask the Trustee to either (i) exercise a Power to Adjust to treat the lifetime beneficiaries and the remaindermen more equitably, or (ii) opt into a statutory Unitrust regime. Both the Power to Adjust or the Unitrust can facilitate more contemporary "Total Return" investing by the Trustee. New York has both options available to Trustees. The Power to Adjust, which permits the Trustees to periodically assess the economic and investment environment as well as the beneficiary's personal circumstances, is the most popular because it has the most flexibility.
5. **Exercising a Power of Appointment.** Given the current transfer tax landscape with a significant estate tax exclusion available at the Federal level, some prospective beneficiaries may actually want to see assets included in the gross estate of a senior family member at death so that a basis step-up can be obtained. In certain states that do not prohibit it by statute, this can often be achieved by intentionally

exercising a power of appointment to appoint assets in a way that violates the applicable Rule Against Perpetuities. This is referred to as triggering the “Delaware tax trap.”

These five techniques are reasonably straightforward. **Two Other Strategies** that involve combining concepts are less straightforward but worth mentioning:

- **Move First.** When the terms of the governing instrument and applicable law do not provide the relief that may be needed in the case of an irrevocable trust, a Trustee can consider moving the trust to another situs, or jurisdiction, before taking appropriate action. After the move, if authorized by the governing instrument or pursuant to a court proceeding, the Trustee may be in a position to decant, to use a non-judicial settlement agreement to resolve an issue, to pursue a construction proceeding, or other technique.
- **Reformation.** When the circumstances justify it, a local court having jurisdiction over a trust may be willing to modify the terms of the trust. Generally, the Trustee seeking this relief will need to show an inadvertent mistake of fact, or contrary advice having been provided to the creator of the trust that amounts to a mistake of law. Sometimes the reformation will be conditional on the taxpayer procuring a favorable Private Letter Ruling as to the tax implications. This procedure is typically a more complex fix.

And When Time Permits - Disclaimer. We should note that, if time permits, the beneficiary of an irrevocable trust could disclaim, or renounce, an interest in order to allow it to pass to other beneficiaries, perhaps junior family members. However, to avoid gift tax consequences for the disclaiming beneficiary, the disclaimer must be irrevocably made within nine months after the original transfer.

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Flexibility. In the case of any newly created trusts, the flexibility to make future adjustments is enhanced by incorporating provisions that expressly authorize (i) a transfer of situs by the Trustee if it is in the best interest of the beneficiaries, (ii) a decanting procedure, (iii) the granting of a general power of appointment to a beneficiary, or (iv) a termination of the trust altogether in favor of a complete distribution of the trust assets.

Caveat. Depending on the circumstances, there can be a tax-related downside in taking advantage of certain of the methods noted above. Care should be taken not to inadvertently trigger a tax. For example, when the original trust or arrangement is irrevocable and the beneficiaries are legally required to consent to a modification that is favorable for one but not all of them, there could be gift tax implications for a consenting beneficiary. Likewise, a Trustee’s exercise of a decanting power that extends the term of a grandfathered GST Trust can have severe GST tax consequences for the beneficiaries. Please seek advice from us or other tax and planning advisors before utilizing any of the strategies mentioned above.

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Considerable thought goes into irrevocable estate planning actions. Yet changes in circumstances for a beneficiary or a family can make the original plan unsuitable, and modifications of the applicable Federal or State tax rules can render even the most sophisticated planning obsolete. The good news is that there are a variety of ways to refresh, improve or re-design the brittle bones of an older estate plan, even one that is expressly irrevocable. Often, the fix is easy to accomplish, as noted at the outset, and sometimes the necessary adjustments may be more challenging but still feasible and worthwhile.

This Advisory is provided as general information only. No action should be taken solely on the basis of its contents.

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