

REID LAW ASSOCIATES PLLC

777 THIRD AVENUE
NEW YORK, NY 10017

Tel: 646-445-5100

www.reidpllc.com

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IF IT'S BROKE – FIX IT

Solving Trust Problems in the Twenty-First Century

Trusts are often regarded as the single most effective and ubiquitous estate planning tool. Yet, clients often consult us about the terms of older trusts that may have been put in place at a time when the applicable laws or family objectives were different. Even the terms of a trust created just a few years ago may not be optimal due to a change in life circumstances or the applicable Federal or State tax rules. Typically, the trust in question 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. Depending on the circumstances, a number of fixes may be appropriate – either as a standalone method, or in combination with other options on this list:

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 fund a business that would not otherwise be a suitable trust investment.

Statutory Revocation or Amendment. 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.

Decanting. If Trustees have sufficient discretion, they may be able to pour an existing irrevocable trust 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 alter the interest of an original beneficiary. In the absence of a statute, common law decanting may be an option.

Unitrust and Power to Adjust. When the lifetime beneficiary's cash flow is a concern, a remainder beneficiary is focused on long-term investment decisions, or the investments produce receipts difficult to allocate between income and principal, one solution that can satisfy everyone may be to either (i) exercise a Power to Adjust to treat the lifetime or the remainder beneficiaries more equitably or (ii) opt into a statutory Unitrust regime. Both can facilitate more contemporary "Total Return" investing and both are available to New York 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, can also avoid complex accounting exercises when a trust holds illiquid assets or alternative investments.

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 benefit from the inclusion of assets in the gross estate of a senior family member at death so that a basis step-up can be obtained. In some instances, an existing power of appointment in the trust can be exercised to appoint assets in a way that violates the applicable Rule Against Perpetuities; this is referred to as triggering the "Delaware tax trap." In other cases, a Trustee may grant a general power of appointment not previously granted to a beneficiary in the trust agreement, so that some or all of the trust assets are includible in the beneficiary's estate.

Earlier this year we welcomed back CYNTHIA G. CHAMBERS, who re-joined us as a Senior Estate Administrator focused on the effective administration of more complex estates and trusts.

Moving. 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 the law of the new jurisdiction, 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.

When Time Permits - Disclaiming. 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 trust, the flexibility to make future adjustments may be 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 customized decanting procedure that does not require court or beneficiary approval, (iii) the granting of a general power of appointment to a beneficiary, or withdrawal of such a power, or (iv) a termination of the trust altogether in favor of a complete distribution of the trust assets.

Caveat. Depending on the circumstances, certain of the strategies noted above require careful planning to avoid an inadvertent tax consequence. For example, when the original trust is irrevocable and the beneficiaries are 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. Please reach out to us if you would like to discuss an existing irrevocable trust in your estate plan, or any other estate planning questions you may have.

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

REID LAW ASSOCIATES PLLC

James W. Reid, Esq.
jreid@reidpllc.com
646-445-5103

Amanda L. Spiro, Esq.
aspiro@reidpllc.com
646-445-5101

Cynthia G. Chambers
cchambers@reidpllc.com
646-445-5100

Lesya Osipova
losipova@reidpllc.com
646-445-5104