Giving Your Trust a Facelift: Trust Modification

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Occasions may arise such that one might want to "fix" or change something about a trust in order to accomplish certain goals. Perhaps there is an unexpected change in facts or in applicable tax laws. Maybe the trustee succession provisions can be improved. This outline touches, broadly, on certain ways to give a tired trust a "facelift" or otherwise "freshen up" a trust, or even improve it, and focuses on modification of trusts. This outline does not address technical tax issues that might also be involved; those issues are beyond the scope of these materials.

[1] October 2013. These materials are based on an outline entitled "Giving Your Trust a Facelift: Modification and Change of Situs" prepared by Margaret E.W. Sager and Bradley D. Terebelo in 2008, as revised through 2011.

I. THE UNIFORM TRUST CODE

A. The Uniform Trust Code ("UTC") was completed by the Uniform Law Commissioners in 2000, and amended in 2001, 2003, 2004, 2005 and 2010. The goal of the UTC was to "provide States with precise, comprehensive, and easily accessible guidance on trust law questions. On issues on which States diverge or on which the law is unclear or unknown, the Code will for the first time provide a uniform rule. The Code also contains a number of innovative provisions." UTC PREFATORY NOTE. *Twenty-six jurisdictions* have adopted versions of the UTC: Alabama, Arizona, Arkansas, the District of Columbia, Florida, Kansas, Maine, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia and Wyoming. As of April 2013, New Jersey introduced (but had not yet adopted) the UTC. http://www.uniformlaws.org/Act.aspx?title=Trust Code.

B. Arizona initially enacted a version of the UTC in 2003. Arizona's 2003 UTC was repealed shortly thereafter following public concern about certain notice provisions regarding a trustee's duties to inform beneficiaries of a trust's specific assets, changes to the trust's assets, beneficiary distribution, and other details of the trust. Arizona adopted a new version of the UTC in 2008, effective January 1, 2009. Arizona's new UTC now provides that a settlor can provide in a trust that no affirmative notice need be provided to beneficiaries (except that a trustee must respond to reasonable requests from certain "qualified beneficiaries"). A.R.S. §§ 14-10105(B)(8), 14-10813.

C. Pennsylvania enacted the "Uniform Trust Act" ("UTA"), generally effective November 6, 2006, adopting a customized version of the UTC, more so than many other states adopting the UTC.

D. The first portion of this outline compares various provisions of the UTC with comparable provisions of Arizona's UTC and Pennsylvania's UTA. The comparisons will hopefully be useful to show where, and why, Arizona's UTC and Pennsylvania's UTA differ from the UTC.

II. WITHOUT COURT APPROVAL

A. UTC:

1. The UTC permits a noncharitable irrevocable trust to be modified or terminated upon consent of the settlor and all beneficiaries "even if the modification or termination is inconsistent with a material purpose of the trust." UTC §411(a). Thus, undesirable

provisions can be removed, "defective" provisions can be "repaired" and the entire trust can be terminated without the involvement of a court so long as all beneficiaries and the settlor consent.

(a) Note that UTC §411(a) does not address whether it would apply in situations where there are two or more co-settlors and one or more co-settlors consents to the modification but one or more co-settlors are unwilling or unable to consent.

2. Nonjudicial Settlement Agreement:

(a) UTC §111(b) provides that "interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust."

(b) An interested person is an individual or entity "whose consent would be required in order to achieve a binding settlement were the settlement to be approved by the court." UTC §111(a). Note that pursuant to the definition of UTC §111(a), an interested person is not the same in every instance.

(c) A nonjudicial settlement agreement is only valid "to the extent it does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court[.]" UTC §111(c).

(d) UTC §111(d) provides a nonexclusive list of matters which may be resolved by a nonjudicial settlement agreement.

(e) Any party in interest may petition the court to approve a nonjudicial settlement agreement, determine whether the virtual representation, if any, was adequate (virtual representation is discussed below) and to determine whether the agreement "contains terms and conditions the court could have properly approved." UTC §411(e).

B. Arizona:

1. Arizona has not adopted UTC §411(a). Arizona requires court approval for the modification or termination of noncharitable irrevocable trusts by consent. A.R.S. §14-10411.

2. Nonjudicial Settlement Agreement: Arizona's nonjudicial settlement statute, A.R.S. §14-10111, is almost identical to UTC §111. The Arizona statute adds a provision, A.R.S. §14-10111(E),

which clarifies that upon the request of an interested party for court approval of an agreement, the court may simply decline to approve the agreement without any resulting prejudice to the effectiveness of the agreement, unless the interested party specifically requests that the court disapprove or deny the effectiveness of the agreement.

3. Under Arizona law, an "interested person"

> includes any trustee, heir, devisee, child, spouse, creditor, beneficiary, person holding a power of appointment and other person who has a property right in or claim against a trust estate or the estate of a decedent, ward or protected person. Interested person also includes a person who has priority for appointment as personal representative and other fiduciaries representing interested persons. Interested person, as the term relates to particular persons, may vary from time to time and must be determined according to the particular purposes of, and matter involved in, any proceeding.

A.R.S. §14-1201.

C. Pennsylvania:

1. Adopting the UTC, Pennsylvania permits the modification or termination of noncharitable irrevocable trusts without court approval provided that the settlor and all beneficiaries agree to the modification or termination. 20 Pa. C.S. §7740.1.

2. Pursuant to 20 Pa. C.S. §7703, a beneficiary is an individual who or entity that:

> "(1) has a present or future beneficial interest in a trust, vested or contingent; or
> (2) in a capacity other than that of trustee or protector, holds a power of appointment over trust property."

3. Nonjudicial Settlement Agreement:

(a) Pennsylvania's nonjudicial settlement agreement statute, 20 Pa. C.S. §7710.1, is substantially similar to UTC §111, although 20 Pa. C.S. §7710.1(a) provides with more specificity that "all beneficiaries and trustees of a trust may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust." The requirement that all beneficiaries and trustees execute the nonjudicial

settlement agreement, although arguably more onerous, removes the uncertainty of UTC §111, which only requires that "interested persons" execute the agreement, which can change depending on the matter being resolved.

(b) As with UTC §411(c), a nonjudicial settlement agreement in Pennsylvania is only valid "to the extent that it does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court[.]" 20 Pa. C.S. §7710.1(c).

(i) ***Practice Tip:*** If modification of a trust will violate a material purpose of the trust, it may not be modified by nonjudicial settlement agreement. If the settlor is alive and will consent, the trust may still be modified without court approval pursuant to 20 Pa. C.S. §7740.1(a) (discussed above). If the settlor is not alive or will not consent, it is not likely the trust may be modified via nonjudicial settlement agreement, and it may be necessary to petition the court to modify or reform the trust under other provisions of the UTA.

(c) 20 Pa. C.S. §7710.1(d) expands on the nonexclusive list of matters which may be resolved by nonjudicial settlement agreement under UTC §711(d), including "modification or termination of a trust[.] 20 Pa. C.S. §7710.1(d)(11).

(d) Similar to UTC §411(e), 20 Pa. C.S. §7710.1(e) provides that "any beneficiary or trustee of a trust may request the court to approve a nonjudicial settlement agreement to determine whether the representation as provided in Subchapter C [concerning virtual representation, discussed below] was adequate or whether the agreement contains terms and conditions the court could have properly approved."

Practice Tip: Note that a court need only determine whether it "could" have approved a modification contained in a nonjudicial settlement agreement, not whether it would have approved the modification. Based on this lower standard of review, if parties in interest would like to seek court approval for a modification of a noncharitable trust, practitioners should consider modifying the trust via nonjudicial settlement agreement and then petitioning for approval pursuant to 20 Pa. C.S. §7710.1(e), as opposed to

petitioning the court to approve the modification directly pursuant to 20 Pa. C.S. §7740.1(b) (discussed below).

4. 61 Pa. Code §94.3

(a) Effective for all resident and non-resident Pennsylvania inheritance tax returns filed on or after July 1, 2012, 61 Pa. Code §94.3(a) provides that if the person responsible for filing the return has not made an election to prepay [inheritance] tax . . . concerning trust assets reported on the return as part of a qualified spousal trust . . .[,] the Department will reserve the right to assess Pennsylvania Inheritance Tax at the highest applicable rate in effect at the time the Department issues its initial Notice of Inheritance Tax Appraisement, Allowance or Disallowance of Deductions and Assessment of Tax, unless the person responsible for filing the return requests a Future Interest Compromise from the Department[.]"

(b) If a Future Interest Compromise is not requested, the "person responsible for filing the return shall acknowledge in writing, in the form and manner provided by the Department, the person's assumption of liability for inheritance tax consequences that result from the termination of a trust under 20 Pa.C.S. §7710.1 (relating to nonjudicial settlement agreements—UTC 111) that occurs after the return has been filed. This assumption of liability applies to a termination made without court approval or notice to the Department. This liability does not apply to a termination made under a specified termination date as contained within the trust instrument provided to the Department." 61 Pa. Code §94.3(b). In calculating the amount of inheritance tax due, "the assets of the trust will be valued for Pennsylvania Inheritance Tax purposes as of the date of termination and tax will be due and owing as of the date of termination. Interest will accrue on an inheritance tax liability as of the termination date and in accordance with section 806 of The Fiscal Code (72 P.S. §806)." 61 Pa. Code §94.3(c).

(c) It appears that the main purpose of 61 Pa. Code §94.3 is to require trusts that qualify for the marital deduction that would otherwise be subject to Pennsylvania inheritance tax at the death of the surviving spouse to pay such tax if and when the trust is terminated early without court approval pursuant to 20 Pa. C.S. §7710.1. In other words, the Pennsylvania Department of Revenue does not what those

trust assets to escape taxation simply due to early termination under the statute, and is seeking to "encourage" payment of the tax by requiring the trustees to state that they are assuming the liability for the tax if the trust is terminated early under the statute. Query would 61 Pa. Code §94.3 have a possible chilling effect on the willingness of trustees to consent to the termination of a trust under the statute?

III. WITH COURT APPROVAL

A. UTC:

1. With consent of all beneficiaries: If all beneficiaries wish to terminate a noncharitable irrevocable trust, a court can terminate a trust if it "concludes that continuance of the trust is not necessary to achieve any material purpose of the trust." UTC §411(b). If all beneficiaries wish to modify a noncharitable irrevocable trust, but the settlor has died, a court can modify the trust if it "concludes that modification is not inconsistent with a material purpose of the trust." *Id.*

2. If not all beneficiaries consent: A court can modify or terminate a noncharitable irrevocable trust, without the consent of the settlor and without the consent of all of the beneficiaries, if the trust could have been modified or terminated under UTC §411(a)-(b) had all beneficiaries consented and "the interests of a beneficiary who does not consent will be adequately protected." UTC §411(e). The comment to UTC §411(e) states that subsection (e) "allows the court to fashion an appropriate order protecting the interests of the nonconsenting beneficiaries while at the same time permitting the remainder of the trust property to be distributed without restriction. The order of protection for the nonconsenting beneficiaries might include partial continuation of the trust, the purchase of an annuity, or the valuation and cashout of the interest."

3. A beneficiary under the UTC (UTC §103(2)) is an individual or entity that:

"(A) has a present or future beneficial interest in a trust, vested or contingent; or
(B) in a capacity other than that of trustee, holds a power of appointment over trust property."

4. UTC §411(c) provides that a spendthrift provision is not presumed to be a material purpose of the trust.

B. Arizona:

1. The Arizona statute, A.R.S. §14-10411, mirrors UTC §411(b), (d) and (e), except that Arizona is silent with respect to whether or not a spendthrift provision is presumed to be a material purpose of the trust.

2. A beneficiary in Arizona is the same as a beneficiary under UTC §411. A.R.S. §14-10103.

C. Pennsylvania:

1. If all beneficiaries wish to modify or terminate a noncharitable trust, but the settlor has died (or does not consent), then a court can modify or terminate the trust on the same grounds as provided for in UTC §411(b). 20 Pa. C.S. §7740.1(b).

2. Contrary to UTC §411(c), under 20 Pa. C.S. §7740.1(b.1), a spendthrift provision is presumed to be a material purpose of the trust.

3. ***Practice Tip:*** When does a provision constitute a material purpose of the trust? Other than 20 Pa. C.S. §7740.1(b.1), concerning spendthrift provisions, little guidance is provided, and determining whether a modification will violate a material purpose of the trust will need to be done on a case-by-case basis. Practitioners must be especially careful that modifications of dispositive provisions will not violate a material purpose of a trust. Although it would appear that certain administrative provisions (such as trustee succession provisions) may be more freely modified without violation of a material purpose of a trust, even modifications of administrative provisions may violate a material purpose of the trust depending on the circumstances. For example, if the testator of a testamentary trust appoints a corporate trustee, if the beneficiaries wish to modify the trust to permit the removal of the corporate trustee, does that violate a material purpose of the trust? Does the testator's appointment of a corporate trustee mean that the testator always intended that a corporate trustee (or, more specifically, the named corporate trustee) serve? For cases discussing material purpose, *see Stern Trust*, 29 Fid. Rep. 2d 207 (O.C. Mont. 2009) (annotated in the Fiduciary Review, June 2009); *In Re: C. Richard Johnston Irrevocable Trust*, O.C. 2011-135 (O.C. Crawford, January 19, 2012); and *Hendrickson Trusts*, 3 Fid. Rep. 3d 55 (Chancery Div. Burlington, N.J., 2012), annotated in the *Fiduciary Review*, March 2013, all of which are discussed below.

4. If not all beneficiaries consent, then 20 Pa. C.S. §7740.1(d) still permits modification of the trust on the same basis as UTC §411(e).

5. A beneficiary in Pennsylvania is the same as a beneficiary under UTC §103(2). 20 Pa. C.S. §7703.

IV. CHARITABLE TRUSTS AND CY PRES

A. UTC:

1. Pursuant to UTC §413(a), "if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve or wasteful . . . a court may apply cy pres to modify or terminate a trust "in a manner consistent with the settlor's charitable purposes[,]" provided that the trust does not fail in whole or in part and the trust property does not revert to the settlor or the settlor's successors in interest.

2. UTC §413(b) provides that a "provision in the terms of a charitable trust that would result in distribution of the trust property to a noncharitable beneficiary prevails over the power of the court under [UTC §413(a)] to apply cy pres . . . if "the trust property is to revert to the settlor and the settlor is still living; or . . . fewer than 21 years have elapsed since the date of the trust's creation." The comment to UTC §413 states that subsection (b) was included to respond to "concerns about the clogging of title and other administrative problems caused by remote default provisions upon failure of a particular charitable purpose[.] . . . Subsection (b) will not apply to a charitable lead trust, under which a charity receives payments for a term certain with a remainder to a noncharity."

B. Arizona:

Arizona's cy pres statute, A.R.S. §14-10413, is identical to UTC §413.

C. Pennsylvania:

1. 20 Pa. C.S. §7740.3(a) provides that "if a particular charitable purpose becomes unlawful, impracticable, or wasteful . . . a court shall apply cy pres to fulfill as nearly as possible the settlor's charitable intention, whether it be general or specific[,]" provided that the trust does not fail in whole or in part and the trust property does not revert to the settlor or the settlor's successors in interest. Note that 20 Pa. C.S. §7740.3(a) directs the court to apply cy pres in that instance, whereas under UTC §413(a), the court's ability to apply cy pres is discretionary.

2. 20 Pa. C.S. §7740.3(b) provides that a provision in the terms of a charitable trust which results in distribution of the trust property to a noncharitable beneficiary prevails over the power of the court to apply cy pres. This is different than UTC §413(b), discussed above, which provides that provisions for noncharitable beneficiaries prevail over the ability of the court to apply cy pres in limited circumstances. The Pennsylvania Comment notes that 20 Pa. C.S. §7740.3(b) "reflects a judgment that there is no public policy reason to refuse enforcement of a settlor's expressed intent to divert the assets of a charitable trust to noncharitable beneficiaries."

3. 20 Pa. C.S. §7740.3(c) is not found in the UTC and permits a court to "modify an administrative provision of a charitable trust to the extent necessary to preserve the trust." The Pennsylvania Comment notes that this subsection codifies existing Pennsylvania law.

4. ***Practice Tip:*** 20 Pa. C.S. §7740.3(c) can be useful to modify trustee succession provisions of a charitable trust, such as to permit a trustee to appoint his, her or its successor.

5. 20 Pa. C.S. §7740.3(d) is also not found in the UTC and permits the trustee, without court approval, to terminate a charitable trust holding an amount less than $100,000, with the consent of the Attorney General and all charitable organizations. The Pennsylvania Comment notes that this subsection reflects former 20 Pa. C.S. §6610(b) but increases the maximum amount from $10,000 to $100,000.

6. 20 Pa. C.S. §7740.3(e) is also not found in the UTC. It permits judicial termination of a charitable trust created solely for charitable purposes, with notice to the Attorney General, if the administrative expenses or other burdens are unreasonably out of proportion to the charitable benefits. It is based on former 20 Pa. C.S. §6110(c).

D. Is a Trust a Charitable Trust or a Noncharitable Trust? Certain provisions of both the UTC and the UTA only apply to noncharitable trusts. When a trust has both charitable and noncharitable interests, which provisions apply? Is any trust with a charitable interest a "charitable trust," even if the charitable interest is a remote contingent interest?

1. Pursuant to UTC §103(4), a charitable trust is a "trust, or portion of a trust, created for a charitable purpose[.]" Pennsylvania's definition of a charitable trust is identical. *See* 20 Pa. C.S. §7703. The Comment to UTC §103 states that "when a trust has both

charitable and noncharitable beneficiaries only the charitable portion qualifies as a 'charitable trust' (paragraph (4)) [. . .] To the extent of these distinctions, a split-interest trust is subject to two sets of provisions, one applicable to the charitable interests, the other the noncharitable." UTC §103 Comment. *See also Flagg Trust* 29 Fid. Rep. 2d 203 (O.C. Mont. 2009) (annotated in the Fiduciary Review, May 2009), which explicitly applied the above-quoted comment to Pennsylvania trusts. Therefore, if the proposed modification will not affect a trust's charitable interests, the trust is a noncharitable trust for the purpose of that modification.

2. Note, however, that even though a trust may be a "noncharitable trust" for the purposes of modification, notice may still need to be provided to the Attorney General if there is a charitable interest pursuant to 20 Pa. C.S. §7710(d) (*see also* UTC §110(c)).

3. ***Practice Tip:*** The Attorney General is not likely to consent to and join in a nonjudicial settlement agreement or petition to modify a trust and instead will issue a "Statement of No Objection" if it does not object to the proposed modification. If parties in interest are seeking court approval to modify a trust, the Statement of No Objection should be obtained prior to filing the petition to expedite the approval process.

V. UNANTICIPATED CIRCUMSTANCES

A. UTC: A court can modify or terminate an irrevocable trust (charitable or noncharitable) if, "because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust" or continuation of the trust on its existing terms would be impractical. UTC §412. To the extent practicable, "modification must be made in accordance with the settlor's probable intention." UTC §412(a).

B. Arizona: The Arizona statute governing modification due to unanticipated circumstances, A.R.S. §14-10412, is identical to UTC §412(a)-(c).

C. Pennsylvania: The Pennsylvania statute governing modification due to unanticipated circumstances is identical to UTC §412(a), except that the provision only applies to noncharitable trusts. 20 Pa. C.S. §7740.2.

VI. UNECONOMIC TRUSTS

A. UTC:

1. A trustee after notice to qualified beneficiaries, without court approval, may terminate a trust if the trust value is less than $50,000 and the trustee concludes that the "value of the trust property is insufficient to justify the cost of administration." UTC

§414(a). The Comment to UTC §414(a) notes that the $50,000 threshold amount may be modified by the adopting jurisdiction as it sees fit.

2. A court may modify or terminate a trust, or remove a trustee of a trust and replace that trustee with another (presumably less expensive) trustee, "if it determines that the value of the trust property is insufficient to justify the cost of administration."

3. UTC §414 does not apply to an easement for conservation or preservation. UTC §414(e).

B. Arizona: Arizona's statute concerning terminating uneconomic trusts is substantially similar to UTC §414. However, Arizona permits the termination of trusts that (1) fall below a "threshold amount" of $100,000, or (2) are otherwise "uneconomic to administer." A.R.S. §14-10414.

C. Pennsylvania: Pennsylvania also permits the termination of noncharitable trusts for economic reasons. 20 Pa. C.S. §7740.4. The provisions of the statute are substantially similar to UTC §414. However, unlike UTC §414(a), which sets a threshold amount before a trustee can terminate a trust for economic reasons and does not explicitly require beneficiary consent, 20 Pa. C.S. §7740.4(a) does not set a threshold amount (the trustee must simply determine that the value of the trust property is insufficient to justify the cost of administration) and requires that qualified beneficiaries be notified at least sixty days in advance of the proposed termination and that there be no objection from a beneficiary.

VII. REFORMATION TO CORRECT MISTAKES

A. UTC: A court can "reform" (as opposed to "modify") the terms of a trust, "even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement." UTC §415. The Comment to UTC §415 is quick to distinguish reformation, which "may involve the addition of language not originally in the instrument, or the deletion of language originally included by mistake, if necessary to conform the instrument to the settlor's intent[,]" from resolving an ambiguity, which concerns interpretation of language in the trust document itself.

B. Arizona: Arizona's reformation statute is identical to UTC §415. A.R.S. §14-10415.

C. Pennsylvania: Pennsylvania's reformation statute is substantially similar to UTC §415, although the statute requires that reformation be "proved by clear and convincing evidence that the settlor's intent *as expressed in the trust* instrument was affected by a mistake of fact or law, whether in

expression or inducement." 20 Pa. C.S. §7740.5 (emphasis added). The Pennsylvania Comment to 20 Pa. C.S. §7740.5 states that the italicized addition "is a clarification of the UTC and consistent with the refusal to recognize oral trusts in Pennsylvania." In addition, Pennsylvania allows the court to give the reformation retroactive effect. UTC §415 is silent regarding retroactivity.

VIII. MODIFICATION TO ACHIEVE SETTLOR'S TAX OBJECTIVES

A. UTC: So long as the modification is not "contrary to the settlor's probable intention," a court may modify the trust to achieve the settlor's tax objective, even giving it retroactive effect. UTC §416. The Comment to UTC §416 notes, however, that whether the modification made by the court will be recognized under federal tax law is a matter of federal law: "Absent specific statutory or regulatory authority, binding recognition is normally given only to modifications made prior to the taxing event, for example, the death of the testator or settlor in the case of the federal estate tax. *See* Rev. Rul. 73-142, 1973-1 C.B. 405." UTC §416, Comment.

B. Arizona: Arizona's equivalent statute is identical to UTC §416. A.R.S. §14-10416.

C. Pennsylvania: Pennsylvania's equivalent statute is essentially identical to UTC §416. 20 Pa. C.S. §7740.6.

D. Examples might include modifications to change the Crummey withdrawal powers of an irrevocable insurance trust, to qualify a trust as in IRA pass-through, to permit distributions from a marital trust to enable the surviving spouse to engage in estate planning, and so on.

E. *See* "Tax Concerns" below.

IX. DIVISION AND COMBINATION OF TRUSTS

A. UTC: The UTC permits combination or division of trusts after "notice to the qualified beneficiaries . . . if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust." UTC §417. There is no mention made regarding whether court approval is needed. The Comment to the provision states that the section "allows a trustee to combine two or more trusts even though their terms are not identical," and permits division "even if the trusts that result are dissimilar." UTC §417.

B. Arizona: Arizona's division and combination is essentially identical to UTC §417, except that notice does not need to be given to qualified beneficiaries if the trust instrument provides that notice is not required. A.R.S. §14-10417.

C. Pennsylvania: Pennsylvania has not adopted UTC §417.

1. Division of Trusts:

(a) Without court approval: A trustee may divide a trust without court approval, "allocating to each separate trust either a fractional share of each asset and each liability held by the original trust or assets having an appropriate aggregate fair market value and fairly representing the appreciation or depreciation in the assets of the original trust as a whole." 20 Pa. C.S. §7740.7(a). There is no mention of beneficiary consent or notice.

(b) With court approval: A court can authorize the division of a trust into two separate trusts "for cause shown . . . upon such terms and conditions and with notice as the court shall direct." 20 Pa. C.S. §7740.7(b).

(c) ***Practice Tip:*** Practitioners should review whether the dispositive provisions of a trust which will be divided should also be modified to ensure that the income and principal is only distributed to the beneficiaries for whom the divided trust was set aside in order to prevent possible arguments in the future that the trusts should recombine by its terms.

2. Combination of Trusts:

(a) Without court approval: A trustee can combine trusts "that were created under the same or different instruments if the trusts have identical provisions, tax attributes and trustees." 20 Pa. C.S. §7740.8(b). Again, there is no mention of beneficiary consent or notice.

(b) With court approval: A court may "for cause shown . . . authorize the combination of separate trusts with substantially similar provisions upon terms and conditions and with notice as the court shall direct notwithstanding that the trusts may have been created by separate instruments and by different persons." 20 Pa. C.S. §7740.8(a). Unlike trust combination without court approval, which requires *identical* trust provisions, court approved combination only requires that the terms be *substantially similar*.

X. VIRTUAL REPRESENTATION

A. UTC: Virtual representation provisions under the UTC are found at UTC §§ 301 through 305 and provide that under certain circumstances a person or entity may represent and bind another person or entity with respect to trust matters (which include, but are not limited to, petitions to the court to modify a trust, nonjudicial modification of a trust, trust division and recombination, trustee appointment and succession, and change of situs).

1. UTC §302 provides that the possessor of a general testamentary power of appointment may represent all appointees and takers in default of the exercise of a power of appointment to the extent that there is no conflict of interest between the representative and the represented parties in the matter being resolved.

2. UTC §303 provides that, to the extent that there is no conflict of interest between the representative and the represented parties in the matter being resolved, certain fiduciaries (such as a guardian representing his or her ward or the personal representative representing beneficiaries in the estate) may represent individuals or entities, and a parent may represent his minor or unborn child. In addition, UTC §303(4) provides that a trustee may represent the beneficiaries of a trust. Note, however, that under UTC §411(a) (modification upon consent of the settlor and all beneficiaries), an agent under a power of attorney may only represent the settlor/principal to the extent the agent is specifically authorized to do so, and a conservator or guardian may only represent a settlor upon approval of the court.

3. UTC §304 contains a "catch-all" provision and provides that a person or entity having a substantially identical interest to an unrepresented minor, incapacitated, unborn or unascertained person or entity may represent the unrepresented person or entity to the extent that there is no conflict of interest.

4. UTC §301(b) provides that representation of a represented party is ineffective if the represented party objects.

B. Arizona: Arizona's virtual representation statutes, A.R.S. §14-10301 and A.R.S. §§14-1404 to -1408, are similar to UTC §§301–305:

1. A.R.S. §14-1405 provides that "The holder of a general power of appointment, including a general testamentary power of appointment, may represent and bind persons whose interests, as permissible appointees, takers in default or otherwise, are subject to the power." Unlike UTC §302, there is no requirement that

there cannot be a conflict of interest between the representative and the represented beneficiaries.

2. A.R.S. §14-1406 is almost identical to UTC §303, except that in the case of a parent representing the parent's minor or unborn descendants, "the parent may not represent the child to consent to a modification or a termination of a trust if the parent is the settlor of the trust."

3. A.R.S. §14-1407 is essentially identical to UTC §304.

4. A.R.S. §14-1404(B) provides that representation of a represented party is ineffective if the represented party objects.

5. A.R.S. §14-1404(D) provides that a "person who receives notice on behalf of another person pursuant to this section is not liable to the other person unless the person who receives notice is grossly negligent or acts or fails to act with the intent to harm the other person."

C. Pennsylvania: Pennsylvania's virtual representation statutes (20 Pa. C.S. §§ 7721 through 7726) are somewhat similar to the UTC, but are more expansive than the UTC provisions.

1. 20 Pa. C.S. §7723 sets out rules when a person or entity may represent another. In all but one rule, the representation may occur only to the extent that there is no conflict of interest between the representative and the represented parties in the matter being resolved:

(a) 20 Pa. C.S. §7723(1) provides that a plenary guardian represents his or her ward, and a limited guardian represents the ward within the scope of the limited authority.

(b) 20 Pa. C.S. §7723(2) provides that an agent under a general power of attorney represents the principal and an agent under a limited power of attorney represents the principal within the scope of the limited authority.

Practice Tip: Practitioners should consider adding specific provisions to general powers of attorney to specifically grant the agent the power to modify a trust or consent to the modification of a trust on the principal's behalf.

(c) Under §7723(3), any one or more *sui juris* current beneficiaries can represent any one or more minor, unborn, unknown or unascertained current beneficiaries.

(d) Under §7723(4), any one or more *sui juris* contingent beneficiaries can represent any one or more minor, unborn, unknown or unascertained contingent beneficiaries of the same class.

(e) Under §7723(5), a contingent beneficiary can represent more remote contingent beneficiaries who would take upon the occurrence of a future event, such as the death of the representing contingent beneficiary.

Practice Tip: Representation under §7723(5) is not limited to minor, unborn, unknown or unascertained beneficiaries; thus, a contingent beneficiary may represent more remote contingent beneficiaries even if the more remote contingent beneficiaries are *sui juris*.

(f) 20 Pa. C.S. §7723(6) is the "catch-all" provision similar to UTC §304.

(g) The holder of a general power of appointment or a broad limited power of appointment (i.e., anyone other than the holder's estate, the holder's creditors or the creditors of the holder's estate) represents all potential appointees and all takers in default of the exercise of the power of appointment *whether or not there is a conflict of interest between the representative and the represented parties in the matter being resolved*. 20 Pa. C.S. §7723(7). This is the only situation in which there may be a conflict of interest between the representative and the represented parties in the matter being resolved. Note that this differs from UTC §302, which only permits the holder of a general power of appointment to represent all potential appointees and all takers in default of the exercise of the power to the extent that there is no conflict of interest between the representative and the represented parties in the matter being resolved.

(h) The holder of a power of appointment that is not a general power of appointment or a broad limited power of appointment represents "all potential appointees and all takers in default of the exercise of the power who are also potential appointees," but only to the extent that there is no conflict of interest between the representative and the represented parties in the matter being resolved. 20 Pa. C.S. §7723(8).

(i) A person can represent his or her minor or unborn descendants. 20 Pa. C.S. §7723(9). This differs from UTC §303, which only provides that a parent may represent his or her minor or unborn children.

(j) The ability for a trustee, in his, her or its capacity as trustee, to represent beneficiaries of a trust is removed in 20 Pa. C.S. §7723. Note, however, that it does not preclude a trustee from representing parties to the extent that he, she or it is qualified to do so under 20 Pa. C.S. §7723 (for example, the trustee could still represent his or her descendants under 20 Pa. C.S. §7723(9) to the extent that there is no conflict of interest between the trustee and his or her descendants in the matter being resolved).

(k) Note that under 20 Pa. C.S. §7740.1(a) (nonjudicial modification with the consent of the settlor and beneficiaries), a settlor may not represent a beneficiary under the virtual representation rules. However, the authors believe that this only was meant to apply to a trust for the benefit of third parties, such as is often the case of an irrevocable life insurance trust (and not, say, a trust where the settlor is the sole income and principal beneficiary during his or her lifetime and has a general or broad limited power of appointment over the remaining principal upon the settlor's death), although the statute does not say this.

2. When is there a conflict of interest? Depending on the respective interests in the trusts of the representative and the represented parties there may or may not be a conflict of interest between the representative and the represented party in the matter being resolved. The Pennsylvania Comment to §7723 discusses conflicts of interest with respect to certain scenarios:

"The interplay between paragraphs (4) and (5) is illustrated by the following example. Suppose a trust provides that income is payable to testator's spouse and upon the spouse's death the principal is payable to the testator's children (or descendants of deceased children) and in default of descendants to the testator's heirs. If one or more children are *sui juris*, they represent all the testator's descendants by virtue of paragraph (4), and they represent all heirs by virtue of paragraph (5). Consequently, the *sui juris* children represent other children, descendants and heirs. If the trust were to continue for the children's lives with remainders to grandchildren, the *sui juris* children may represent all children but would not represent the class of grandchildren with respect to

some financial matters because of the conflict of interest between the life and remainder beneficiaries."

3. 20 Pa. C.S. §7724 provides that, in any judicial proceeding, if "the court determines that the representation provided by section 7723 (relating to representatives and persons represented) is or might be inadequate, the court may appoint a guardian ad litem or trustee ad litem to represent the inadequately represented person, class of persons or both."

4. 20 Pa. C.S. §7725 adds a notice requirement to the virtual representation rules, requiring that the trustee give notice to the representative of his, her or its representation of the represented parties. The representative has 30 days to decline the representation. This is not found in the UTC. Note that §7725 requires that the *trustee* give the person notice that he or she will represent another person.

   (a) ***Practice Tip:*** What if the beneficiaries wish to modify a trust to permit removal of the trustee, and the trustee is an adverse party to the proceeding? In such a case, the petitioners and/or parties to the agreement should provide notice of the representation.

   (b) ***Practice Tip:*** The Pennsylvania Comment to Subchapter C (concerning virtual representation) states, "This subchapter takes no position as to the liability, if any, of a representative to the person or persons represented." If a guardian is being asked to represent his, her or its ward or if an agent is being asked to represent his, her or its principal, such fiduciary should consider whether or not to refuse to act as a representative in the event the representation may lead to a breach of his, her or its fiduciary duty.

5. As in UTC §301(b), 20 Pa. C.S. §7726 provides that "a person may not represent another who is *sui juris* and files a written objection to representation with the trustee." This assumes, however, that such person *knows* that he or she is being represented. Although many modification statutes, including 20 Pa. C.S. §7710.1 (nonjudicial settlements) and 20 Pa. C.S. §7740.1 (modification) require that all beneficiaries consent, there is no requirement that all beneficiaries receive notice. Does 20 Pa. C.S. §7726 imply that all beneficiaries need to receive notice even if they are being represented by another? If not all beneficiaries, perhaps all sui juris beneficiaries? In addition, how long does a represented beneficiary have to object? What if the beneficiary does not know

that he or she has been represented until years, or even decades, after the fact?

6. Court's point of view: Courts may be suspicious if the virtual representation is too detached or tenuous and may, in that case, appoint a guardian and trustee *ad litem* to review the matter pursuant to 20 Pa. C.S. §7724. Care should be taken, if possible, to ensure that there are multiple representatives in case one party's representation is deemed to be inadequate.

XI. CASES UNDER THE UNIFORM TRUST ACT

A. *Flagg Trust* 29 Fid. Rep. 2d 203 (O.C. Mont. 2009) (annotated in the Fiduciary Review, May 2009)

1. Testator created a residuary trust under his will, which provided for certain specified amounts from income each year to his children (with a share for a deceased child passing per stirpes to his or her then living descendants). The trustees were also authorized to pay income or, if income is not sufficient, principal, to testator's children and their descendants for "such expenses as may result from illness or similar emergency afflicting any of such income beneficiaries; provided, however, that it first be established that the beneficiary is financially unable to pay such expenses and that bills or similar vouchers for such expenses are submitted to and approved for payment by my executors and trustees." All remaining income was to be distributed in certain proportions to charities. The trust terminates 21 years from the date of death of the last survivor of testator's wife and his descendants living at his death. Testator's four grandchildren were each receiving $20,000 per year pursuant to the terms of the trust. The trust's annual income exceeded $200,000, and so the remaining $120,000+ was passing to the charitable interests. One of testator's grandchildren filed a petition to modify the trust to pay "$25,000, adjusted upward each year for inflation . . . from principal to each of the testator's descendants then entitled to receive income. This payment shall be *in addition* to any income distribution[.]" (Emphasis in original.) The charities, along with the Attorney General, objected to the modification. The court agreed with the Respondents and dismissed Petitioner's petition.

2. The first argument addressed by the court was whether modification was permitted under 20 Pa. C.S. §7740.2(a), which allows a court to modify a noncharitable irrevocable trust "if, because of circumstances that apparently were not anticipated by the settlor, modification will further the purposes of the trust." The court noted that 20 Pa. C.S. §7740.2(a) was derived from UTC

§412, which applied to both noncharitable *and* charitable trusts. Petitioner argued that the Pennsylvania legislature only adopted UTC §412 as it applied to noncharitable trusts in order to "prevent an IRS argument that a trust could not qualify for a charitable tax deduction if the court could modify the charities' interest." Because no charitable deduction was claimed in this case, Petitioner argued the trust was not a charitable trust despite the charitable interests.

(a) The court noted that the UTA does not address the rules that apply to trusts with both charitable and noncharitable beneficiaries, so it turned to the Comment to UTC §103, which defines charitable and noncharitable trusts (discussed in more detail in the "Charitable Trusts" section above).

(b) The court then stated that it "is difficult to conceive of this trust as non-charitable since charitable organizations are entitled to and are currently receiving all excess income not paid to the settlor's descendants. . . . Here, the charities will take nothing upon termination, and, if the requested modification is permitted, there will be an immediate and substantial decrease in the amounts they receive presently." Thus, the court held that the trust was a charitable trust and not subject to modification by 20 Pa. C.S. §7740.2(a).

3. Petitioner also argued that modification was permitted pursuant to 20 Pa. C.S. §7740.3(c), which permits a court to modify the administrative provisions of a charitable trust to the extent necessary to preserve the trust. The court concluded that the modifications requested were dispositive, not administrative, and therefore rejected Petitioner's argument.

4. The court then turned Petitioner's argument that modification was permitted pursuant to 20 Pa. C.S. §7740.5, which permits reformation to correct mistakes. Petitioner argued that there was a mistake of fact in testator's will because it did not take into account how much income would be generated, how many descendants the testator would have and how inflation would rise, which "stymie[d] the testator's intent to provide the means for his family members to live independently." The court rejected this argument, noting that the will "makes no reference to a standard of living. The inquiry into the propriety of reformation begins with the intent *as expressed in the trust instrument*. Clearly the petitioner can not advance his case by relying on Section 7740.5." (Emphasis in original.) In a footnote, the court noted that while testator did not address his descendants' standard of living, testator did intend to provide for them "should they not have sufficient

funds to cover the cost of an illness or other emergency. . . . This provision is indicative of the careful and comprehensive drafting that went into the document, and further militates against allowing a deviation from its express language."

B. *Stern Trust*, 29 Fid. Rep. 2d 207 (O.C. Mont. 2009) (annotated in the Fiduciary Review, June 2009)

1. *Stern Trust* concerned a testamentary trust which provided that the net income was to be paid to testator's wife for life, and upon her death, the principal of the trust is to be divided into three trusts, one for each of testator's children. Testator's family petitioned the court to modify the trust to (i) permit the appointment of two of testator's sons to serve as co-trustees along with testator's wife and to allow each son to appoint his successor, (ii) permit the trustees to distribute principal to testator's wife for her "health, support and maintenance" and (iii) permit testator's wife to appoint the remaining principal of the trust to testator's descendants. A guardian *ad litem* was appointed to represent the interests of minor, unborn and unascertained beneficiaries. The guardian *ad litem* objected to modifications (ii) and (iii).

2. It is not clear in *Stern* why a guardian *ad litem* was appointed. Based on the facts presented, there were *sui juris* beneficiaries of the trust who would be able to represent the interests of minor, unborn and unascertained beneficiaries without a conflict of interest in the matter. It is possible that, pursuant to 20 Pa. C.S. §7724, the court made a *sua sponte* determination that the representation was inadequate and appointed a guardian *ad litem*.

3. Appointment of trustees: The court granted the appointment of testator's sons as co-trustees to serve with testator's wife, noting that 20 Pa. C.S. §7764(e) permits the court to appoint an additional trustee "if the court considers the appointment desirable for the administration of the trust." However, the court rejected the modification to permit the sons to appoint their successors because the modification "goes against this Court's long-held policy that future vacancies should be dealt with as they arise. Accordingly, we will approve only the addition of the two sons as trustees, and, if replacements are needed, they will be chosen in accordance with the provisions of the Uniform Trust Act."

Practice Tip: Despite the court's holding in S*tern*, the authors have filed a number of successful petitions with the court to permit trustees to name their successors.

4. Modification to permit the distribution of principal pursuant to 20 Pa. C.S. §7740.1. Because the guardian *ad litem* objected to the modification of the trust to permit the distribution of principal to testator's wife, the court looked to 20 Pa. C.S. §7740.1(d), which permits a court to approve the modification of a noncharitable irrevocable trust even if a beneficiary objects if the court determines that "(1) if all the beneficiaries had consented, the trust could have been modified or terminated under this section; and (2) the interests of a beneficiary who does not consent will be adequately protected." Because the modification could result in the depletion of the trust, thereby potentially leaving nothing to the remainder beneficiaries, the court held that the interests of the beneficiaries represented by the guardian *ad litem* would be "clearly impact[ed]."[2] In addition, because the trust contained a spendthrift clause, and, pursuant to 20 Pa. C.S. §7740.1(b.1), a spendthrift clause is a material purpose of the trust, the court concluded that modification of the trust was not permitted even if all beneficiaries had consented because 20 Pa. C.S. §7740.1(b) requires that the modification cannot be inconsistent with a material purpose of the trust. Thus, the court did not permit the modification to permit the trustees to distribute principal to testator's wife.

5. Modification to permit testator's wife to appoint the remaining principal to her descendants pursuant to 20 Pa. C.S. §7740.1. Testator's wife and her children, all in agreement, requested that the trust be modified so that testator's wife could appoint the principal to her descendants unequally. This was because one son had managed the family business (the business' stock was held in the trust), and as a result of his management, the business was sold for $20,000,000, and testator's wife and her children all agreed that the son should receive more than the other two children. The court rejected this modification because it "runs contrary to decedent's intent to treat his children equally", and if the family wished to reward the son for his work, they could do so through other means, such as disclaimers, inter vivos gifting or testamentary gifts. Although not addressed by the court, had the court granted the modification, query whether the beneficiaries would be making a taxable gift to the son who would receive more through the power of appointment.

C. *In Re: C. Richard Johnston Irrevocable Trust*, O.C. 2011-135 (O.C. Crawford, January 19, 2012)

[2] Note that 20 Pa. C.S. §7740.1(d)(2) requires that the interests of each beneficiary be "adequately protected"; it does not require, as the court seemed to require here, that a beneficiary's interest cannot be "impacted."

1. In *Johnston*, the settlor created an irrevocable trust in 1981, and he died February 2007 survived by his wife and several children and grandchildren. The trust permitted distributions of income and principal to settlor's widow for her "whenever the Trustees determine that the income from Settlor's wife from all sources known to the Trustees is not sufficient for her reasonable maintenance and support" and to settlor's descendants for their "reasonable maintenance, support and education."

2. In June 2007, the then-serving trustees, settlor's wife and all of settlor's children and grandchildren entered into a nonjudicial settlement agreement pursuant to 20 Pa. C.S. §7710.1 to modify the trust. In the agreement, settlor's descendants gave up their right to receive discretionary distributions of income and principal during the lifetime of settlor's widow, and the trust was further modified to provide that each year the widow was entitled to a 4% unitrust distribution from the trust.

3. In 2011, one of the successor trustees of the trust and two of settlor's children filed a petition to void the agreement, arguing that, because the agreement "was not approved by the Court as required by 20 Pa. C.S.A. §7740.1(b) and because the material purpose of the original trust was improperly negated by that Family Settlement Agreement, it should be voided *ab initio*." Settlor's widow and two of the settlor's other children filed an answer, arguing that the agreement was governed by 20 Pa. C.S. §7710.1 (which does not require court approval to be effective), not §7740.1 (which does require court approval), and that the agreement did not violate a material purpose of the trust.

4. The court analyzed whether the modification of the trust pursuant to 20 Pa. C.S. §7710.1 was proper and concluded that an evidentiary hearing was unnecessary and that, pursuant to the plain language of the trust, the nonjudicial settlement agreement violated a material purpose of the trust for two reasons. One reason was that the agreement "took away the ability of [the settlor's descendants] to receive disbursements from income and principal of the trust during the lifetime of the widow if the trustees determined that those disbursements were necessary for that beneficiaries [*sic*] '… reasonable maintenance, support and education.'" The other reason was as follows:

> With regard to [the settlor's] widow, he did, however, restrict her to only receiving disbursements if the remaining trustees determined that she didn't have enough income from all sources that was sufficient for her reasonable maintenance and support. Clearly the terms of the Family

Settlement Agreement violated that material purpose of the trust. It changed what could have been a $0 disbursement to the widow to an automatic disbursement each year and that clearly was not the intention of the Settlor. By the unambiguous language of the trust, he wanted his widow to be cared for properly during her lifetime with trust funds if she needed them, but he also wanted to preserve the funds for his other beneficiaries by limiting his widow to only receiving disbursements when she did not have other funds "… sufficient for her reasonable maintenance and support."

5. Accordingly, the court invalidated the nonjudicial settlement agreement. However, because the petitioners consented to the settlement agreement initially, the court refused to void the settlement agreement *ab initio* (June 2007), as was requested by the petitioners, and instead invalidated the agreement as of the date of the petition to invalidate the agreement (filed in September 2011). The court therefore ordered settlor's widow to repay to the "beneficiaries of the trust, *pro rata*, any disbursements she received from the trust as a result of the provisions of the June 5, 2007 Family Settlement Agreement from September 15, 2011 forward."[3] In addition, the court directed that the respondents bear the payment of the costs of the action, but not the petitioners' attorney's fees (as was requested by the petitioners).

6. ***Practice Tip:*** To avoid potential uncertainty with nonjudicial settlement agreements being set aside at an indeterminate later date, as occurred in *Johnston*, practitioners may wish to advise clients who are entering into a nonjudicial settlement agreement to obtain court approval of the agreement contemporaneously with the execution of the agreement.

D. *Hendrickson Trusts*, 3 Fid. Rep. 3d 55 (Chancery Div. Burlington, N.J., 2012), annotated in the *Fiduciary Review*, March 2013.

1. *Hendrickson* concerned testamentary trusts created by the plaintiffs' mother and grandmother. Both trusts were "controlled by Pennsylvania law" (presumably because the wills designated that the trusts were governed by Pennsylvania law), although both testators apparently died in Burlington County, New Jersey. Fidelity Philadelphia Trust Company was named co-trustee of the mother's trust and sole trustee of the grandmother's trust.

[3] It is not clear whether the repayment was to be made back to the trust (to be used for permissible distributions to the beneficiaries pursuant to the terms of the trust) or pro rata to each beneficiary directly.

2. Through numerous mergers, Fidelity became Wells Fargo, and the plaintiffs sought to modify the trusts pursuant to 20 Pa. C.S. §7740.1(b) to remove Wells Fargo and appoint The Philadelphia Trust Company as successor trustee.

3. The Chancery Court of Burlington County stated that since the creation of the trusts, "substantial changes to the banking industry have resulted in changes to the performance of administration of the trusts by the corporate trustee. The material purpose of the trust remains unchanged by moving the corporate trustee, Wells Fargo Bank, to a smaller, local bank which focuses on trust administration. The settlors had originally chosen a smaller bank which ultimately, through mergers and acquisitions, became significantly larger than it was over forty years ago." Accordingly, the court modified the trust to provide that the corporate trustee may be removed and replaced by the individual trustees of the mother's trust and by the "Senior Beneficiaries" (as defined therein) of the grandmother's trust.

4. Although it is a New Jersey case, *Hendrickson* is the first case applying Pennsylvania law analyzing whether the designation in a trust of a named corporate trustee without a remove and replace provision is a material purpose of a trust (that is, whether it is "material" that the named corporate trustee must serve in all events). Here, the Court found that what was "material" was that a corporate trustee must serve in all events, not that Fidelity-Philadelphia Trust Company (or its successors) must serve in all events.

5. Compare *Hendrickson* to *McKinney Trusts (No. 2)*, 2 Fid. Rep. 3d 165 (O.C. Crawford 2012), in which the court would not order the removal of the corporate trustee of two trusts, PNC Bank, which was the successor to the original corporate trustee through a series of mergers. Although *McKinney* was a removal action and was not a modification case, Pennsylvania's removal statute (20 Pa. C.S. §7766) requires the court to determine whether the removal "is not inconsistent with a material purpose of the trust." *McKinney* is distinguishable from *Hendrickson* because, unlike *Hendrickson*, where the court held that it was a material purpose that a corporate trustee must serve at all times (but not that the named corporate trustee must serve at all times), in *McKinney,* the court held that, based on the evidence presented specific to the settlor's wishes, the settlor "wanted only successor banks [by merger] to the original trustee to serve as trustee[,]" and therefore removing PNC Bank would be inconsistent with a material purpose of the trusts.

XII. "FAILSAFE" OR "SAVINGS" STATUTORY MODIFICATIONS

A. To the extent that a trust unintentionally creates estate and gift tax consequences under IRC §§ 2041 and 2514 for a trustee or a beneficiary, Pennsylvania has statutory "failsafe" provisions that automatically modify provisions of a trust to remedy the unintended detrimental tax consequence. 20 Pa. C.S. §§ 7501-7506. The failsafe provisions apply to any trust (with certain exceptions) created after March 21, 1999, and any trust created before March 21, 1999 so long as each interested party does not opt out by written declaration. *Id.* at §7503.

B. Unintentional IRC §§ 2514 and 2041 inclusion for trustees: If a trust gives a trustee the ability to make discretionary distributions such that the trust will be included in the trustee's estate for gift and estate tax purposes under IRC §§ 2514 and 2041, 20 Pa. C.S. §7504(a)(1) prohibits a trustee from making "discretionary distributions of either principal or income to or for the benefit of the trustee, the trustees estate, or the creditors of either unless the power is either:" (i) limited by an ascertainable standard; or (ii) exercisable only in conjunction with another person whose interest is adverse to the interest of the trustee.

1. If a trustee is prohibited from exercising her power under 20 Pa. C.S. §7504(a)(1), she can still exercise the power to distribute to anyone other than the trustee, the trustee's estate, or the creditors of either, and she "may exercise that power [for herself] but shall be limited to distributions for the trustee's health, education, support or maintenance…" *Id.* §7504(b). Furthermore, "if the power is conferred on two or more trustees, it may be exercised by the trustee or trustees who are not so prohibited as if they were the only trustee or trustees." *Id.* §7505(1).

2. The failsafe provisions will not apply, however, if the trustee "possesses in his individual capacity an unlimited right to withdraw the entire principal of the trust or has a general testamentary power of appointment over the entire principal of the trust." *Id.* at §7504(c)(1). For trusts created on or before March 21, 1999, the failsafe provision does not apply "if no part of the principal of the trust would have been included in the gross estate of the trustee for Federal estate tax purposes if the trustee had died on March 21, 1999, without having exercised the power of the governing instrument to make discretionary distributions of principal or income to or for the benefit of the trustee, the trustee's estate, or the creditors of either." *Id.* at §7504(c)(2).

C. Unintentional IRC §§ 2514 and 2041 inclusion for beneficiaries: 20 Pa. C.S. §7506(a) prevents a beneficiary of a trust from appointing herself as a trustee or from removing a trustee and replacing the trustee with a

successor trustee who is a related or subordinate party within the meaning of IRC §672(c).

1. The beneficiary can still exercise the power if the trustee's ability to make distributions is limited to an ascertainable standard related to the beneficiary's health, education, support or maintenance; the trustee's power cannot be exercised to satisfy the beneficiary's legal support obligations; and the trustee's discretionary power cannot be exercised to appoint the property of the trust to the beneficiary, the beneficiary's estate, or the creditors of the beneficiary or the beneficiary's estate. 20 Pa. C.S. §7506(a)(1)-(3).

2. The failsafe provisions of 20 Pa. C.S. §7506(a) will not apply if the trustee appointment provision can only be exercised by the beneficiary in conjunction with an adverse party or if the beneficiary has the unlimited ability to withdraw the principal or appoint the principal. *Id.* at §7506(b)(1-2). For trusts created on or before March 21, 1999, the failsafe provision does not apply "if no part of the principal of the trust would have been included in the gross estate of the beneficiary for Federal estate tax purposes if the beneficiary had died on March 21, 1999." *Id.* at §7506(b)(3).

XIII. POWER TO ADJUST AND CONVERSION TO UNITRUST

A. Over the past several years, the fiduciary accounting or "trust" distinction between "income" and "principal" has become increasingly artificial. In the trust administration context, the disparity between dividend and interest rates on the one hand and principal appreciation on the other hand has in many instances induced disparate investment approaches and outcomes for income beneficiaries compared to remainder beneficiaries.

B. To alleviate the "high wire act" trustees often have to walk to attempt to satisfy both the current income beneficiaries and the remainder beneficiaries (and satisfying neither group), many states enacted statutes to address these issues. The statutes, largely based on the Uniform Prudent Investor Act of 1994 and the Uniform Principal and Income Act of 1997, typically permit trusts to be converted to "unitrusts," which require the trustee to pay a fixed percentage of a trust to the erstwhile "income beneficiary," thus giving that beneficiary a share of the trust's total return -- asset performance and interest and dividends -- even if such a total return approach meant that the "income beneficiary" would receive distributions in excess of traditional trust accounting income. Most such statutes also give the trustee the option to exercise a so-called "power to adjust" between principal and income for the benefit of income beneficiaries, such that the trustee could decide on a fairness basis under the circumstances to distribute principal to the income beneficiary.

Although the power to adjust or the power to convert a trust into a unitrust are not modifications of the trust in the traditional sense, the power to convert or the power to adjust gives the trustee, beneficiaries or the court the ability to "fix" defective investment schemes.

C. Arizona:

1. Arizona enacted its version of the Principal and Income Act, A.R.S. §§14-11014 to -11015, in 2008.

2. A.R.S. §14-11014 grants the trustee the power to convert an income trust to a unitrust and reconvert a unitrust back to an income trust without court approval. It also grants the trustee the power to "change the percentage used to calculate the unitrust amount or the method used to determine the fair market value of the trust, or both" without court approval so long as certain conditions are satisfied, including notice and the absence of objection from any notified party.

   (a) However, A.R.S. §14-11015(D) provides that in order for a trustee to have the power to change a unitrust percentage or convert a unitrust to an income trust, the unitrust must grant such power specifically or by reference to A.R.S. §14-11014.

3. A.R.S. §14-11015(E) sets the reasonable apportionment percentage for a unitrust at "not less then three percent nor more than five percent."

D. Pennsylvania:

1. On May 16, 2002, Pennsylvania adopted the Pennsylvania Uniform Principal and Income Act ("PA UP&IA"). 20 Pa. C.S. §§ 8101 to 8113. Since then, the Pennsylvania statute has been the one most often used as a model for other states. *See* Robert B. Wolf, *Total Return - Meeting Human Needs and Investment Goals Through Modern Trust Design*, ACTEC Fall Meeting (Oct. 2004), available at the ACTEC website (www.actec.org). Some highlights of the PA UP&IA:

2. Trustees have the power to make equitable adjustments between the income and principal of a trust and the power to convert the trust to a 4% unitrust if that would fulfill the intent of the settlor and if notice is provided to the sui juris income beneficiaries and presumptive remaindermen. Trustees must consider these powers and make a conscious and impartial decision to exercise these powers, or not, based on what is fair and reasonable to all of the beneficiaries. 20 Pa. C.S. §8103(b). Furthermore, trustees must

consider these powers in conjunction with making investment decisions.

3. Conversion to a unitrust: Unless expressly prohibited by the trust, a trustee can release the power to adjust and convert the trust into a unitrust with a 4% return. If no beneficiaries object, no court approval is required to convert, but if a beneficiary objects or if there is no *sui juris* beneficiary in a particular class to whom notice can be provided, the trustee can petition the court to approve the conversion. In addition, a beneficiary may request the trustee to convert and, if the trustee refuses, the beneficiary can petition the court for approval. 20 Pa. C.S. §8105.

   (a) Once a trustee converts a unitrust, however, the statute requires the trustee to release the power to adjust granted in the statute so that conversion is in place of adjustment and not in addition to it. 20 Pa. C.S. §8105(a). However, the conversion to a unitrust does not affect the powers provided in the governing instrument such as a trustee's power to distribute principal or the beneficiary's power of withdrawal. 20 Pa. C.S. §8105(h). Thus, the trustee must continue to be aware of the trustee's powers under the governing instrument and the trustee's discretionary powers generally, even after converting to a unitrust.

   (b) A trustee can reconvert a unitrust back to a "standard" income trust, following the same notice and consent procedures under 20 Pa. C.S. §8105(a); after the reconversion, the trustee will regain the power to adjust between income and principal. 20 Pa. C.S. §8105(g.1).

   (c) Pennsylvania prohibits a trustee who is also a beneficiary from participating in a decision to convert a trust to a unitrust or to exercise the power to adjust. 20 Pa. C.S. §§ 8104(c)(7); 8105(i)(6). A disinterested co-trustee, however, may participate in such a decision. 20 Pa. C.S. §§ 8104(d); 8105(j)(1). The statute also provides a mechanism for the trustee to petition the court to direct a conversion to a unitrust when no trustee is empowered to make the decision. 20 Pa. C.S. §8105(j)(2). The statute does not contain any authority to petition the court to exercise the power to adjust, presumably because adjustment is an ongoing process in which it would be impractical to involve the court, while conversion is a one time event which can easily be approved by the court.

XIV. DECANTING

A. What is decanting (when there is no wine involved)? In brief, the assets of the "original" trust are "decanted" into or transferred to a new trust with different (and usually viewed as more favorable) trust provisions and/or situs.

B. Currently, 18 states have decanting statutes: Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Missouri, New Hampshire, New York, Nevada, North Carolina, Ohio, Rhode Island, South Dakota, Virginia and Tennessee.

C. Note, however, that other states may permit decanting through common law. Florida common law, for example, permitted decanting for over 65 years under *Phipps v. Palm Beach Trust Company*, 196 So. 299 (Fla. 1940), before it was codified in 2007 under Fla. Stat. §736.04117.

D. Florida (Fla. Stat. §736.04117) requires the trustee of the "original trust" to have absolute discretion under the terms of that trust to invade principal to or for one or more beneficiaries in order to decant, and the new trust must be for the benefit of one or more beneficiaries of the original trust. The absolute discretion requirement makes decanting unavailable for many trusts.

E. Like Florida, New York provides that if the trustee of the "original trust" has absolute discretion under the terms of that trust to invade principal, then the trustee may decant the original trust into a new trust for the benefit of one or more beneficiaries of the original trust. N.Y. EPTL §10-6.6(b)(1). However, pursuant to recently enacted changes to the decanting statute (August 17, 2011), if the trustee does not have the absolute discretion to invade principal, then the trustee may still decant the assets from the original trust into a new trust provided that the new trust contains the same language regarding the trustee's ability to invade principal and the beneficiaries of the new trust are the same as the old trust. N.Y. EPTL §10-6.6(c).

F. Other statutory decanting states, such as Alaska, Arizona, Delaware, Missouri, New Hampshire, Tennessee and South Dakota, do not require that the trustee of the "original trust" have absolute discretion in order to decant into a new trust. For example, under 12 Del. C. §3528, Delaware permits trust assets to be decanted into a new trust if, under the terms of the "original trust," the trustee has the power (unless the governing instrument states otherwise):

> "to invade the principal of a trust (the 'first trust') to make distributions to, or for the benefit of, one or more proper objects of the exercise of the power, [provided that]:

(1) The exercise of such authority is in favor of a second trust having only beneficiaries who are proper objects of the exercise of the power;

(2) In the case of any trust, contributions to which have been treated as gifts qualifying for the [annual] exclusion from gift tax described in § 2503(b) [26 U.S.C. § 2503(b)] of the Internal Revenue Code of 1986 (26 U.S.C. § 1, et seq.) (hereinafter referred to in this section as the "I.R.C."), by reason of the application of I.R.C. § 2503(c) [26 U.S.C. § 2503(c)], the governing instrument for the second trust shall provide that the beneficiary's remainder interest shall vest and become distributable no later than the date upon which such interest would have vested and become distributable under the terms of the governing instrument for the first trust;

(3) The exercise of such authority does not reduce any income or unitrust interest of any beneficiary of a trust for which a marital deduction has been taken for federal tax purposes under I.R.C. § 2056 or § 2523 [26 U.S.C. § 2056 or § 2523] or for state tax purposes under any comparable provision of applicable state law; and

(4) The exercise of such authority does not apply to trust property subject to a presently exercisable power of withdrawal held by a trust beneficiary who is the only trust beneficiary to whom, or for the benefit of whom, the trustee has authority to make distributions."

G. Illinois sets forth different standards for decanting depending on whether or not the trustee has "absolute discretion" to make distributions of principal (which is defined as "the right to distribute principal that is not limited or modified in any manner to or for the benefit of one or more beneficiaries of the trust, whether or not the term 'absolute' is used. A power to distribute principal that includes purposes such as best interests, welfare, or happiness shall constitute absolute discretion"). IL ST CH 760 § 5/16.4

1. Absolute discretion: If a trustee has absolute discretion to distribute principal, then the trustee can decant the principal of the original trust into a new trust, and the beneficiaries of the new trust need not be the same as the beneficiaries of the original trust (although at least one beneficiary must be the same). In addition, the trustee can grant a beneficiary who is a current beneficiary of the original trust a power of appointment over some or all of the principal of the new trust (regardless of whether or not the original trust granted the beneficiary a power of appointment), provided

that the current beneficiary was entitled to receive principal distributions under the original trust. "If the authorized trustee grants a power of appointment, the class of permissible appointees in favor of whom a beneficiary may exercise the power of appointment granted in the second trust may be broader than or otherwise different from the current, successor, and presumptive remainder beneficiaries of the first trust." IL ST CH 760 § 5/16.4(c).

2. No absolute discretion: If a trustee has the power to distribute principal but does not have absolute discretion to distribute principal, then the trustee can still decant the principal of the original trust into a new trust, "provided that the current beneficiaries of the second trust shall be the same as the current beneficiaries of the first trust and the successor and remainder beneficiaries of the second trust shall be the same as the successor and remainder beneficiaries of the first trust." In addition, the new trust "shall include the same language authorizing the trustee to distribute the income or principal of a trust as set forth in the first trust[,]" and "if the first trust grants a power of appointment to a beneficiary of the trust, the second trust shall grant such power of appointment in the second trust and the class of permissible appointees shall be the same as in the first trust." IL ST CH 760 § 5/16.4(d).

H. For excellent discussions on decanting statutes, *see* Richard W. Nenno, *Delaware Trusts 2011*, §28 (Wilmington Trust 2011); William R. Culp, Jr. and Briani L. Bennett, *Use of Trust Decanting to Extend the Term of Irreovcable Trusts,* William R. Culp, Jr. and Briani Bennett Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 34 REAL PROPERTY, TRUST AND ESTATE LAW JOURNAL 1, 1 (Spring 2010); 37 ESTATE PLANNING 6, 3 (June 2010); "State 'Decanting' Statutes," PRACTICAL DRAFTING 9158 (U.S. Trust, January 2008).

XV. TAX CONCERNS:

A. One must be alert to the law of unintended consequences when a trust is modified. What possible negative impact can modification have generally, but specifically what negative tax consequences might there be? Although this outline is not intended to be an in-depth analysis or discussion of the range of possible tax consequences of modifying a trust, which would be beyond the scope of these materials, the following recent IRS Treasury Regulations and private letter rulings cited below illustrate a few tax issues that have arisen in this context.

B. As noted above, the UTA provides that so long as the modification is not "contrary to the settlor's probable intention," a court may modify the trust to achieve the settlor's tax objective, even giving the modification retroactive effect. 20 Pa. C.S. §7740.6. The Comment to UTC §416 (on which 20 Pa. C.S. §7740.6 was based) notes, however, that whether the modification made by the court will be recognized under federal tax law is a matter of federal law: "Absent specific statutory or regulatory authority, binding recognition is normally given only to modifications made prior to the taxing event, for example, the death of the testator or settlor in the case of the federal estate tax. *See* Rev. Rul. 73-142, 1973-1 C.B. 405."

C. Estate Tax Concerns:

1. If a living settlor's irrevocable trust is to be modified under 20 Pa. C.S. §7740.1(a), would the modification cause the value of the trust assets to be included in the settlor's estate? By consenting to the modification, would the settlor be deemed to have retained an interest in or control over the property such that the value of the trust assets would be included in the settlor's estate under IRC §2036 or §2038?

2. In PLR 200730015, the settlor of an inter vivos irrevocable trust wanted a court to modify the terms of the trust and she sought a ruling from the IRS that the modification would not cause the value of the trust assets to be included in her estate. As drafted, the trust provided that the trustee "shall" pay net income and principal to or apply it directly for the benefit of the settlor's descendants. In addition, during the settlor's lifetime, her youngest then living descendant had a limited power of appointment over the principal. The settlor sought a court modification of the trust to change "shall" to "may" and to grant the power of appointment to the settlor's youngest <u>child</u>, not her youngest <u>descendant</u>. The settlor, the scrivener and the trustee (the settlor's youngest child) all submitted affidavits stating that the trust as modified would conform to the settlor's original intent and that the trust provisions to be modified were the result of the scrivener's error. The relevant state law permitted judicial modification of a trust where the evidence "clearly and unequivocally shows that an instrument does not express the true intent or agreement of the parties." The settlor sought a ruling to determine if the modification would cause inclusion of the trust in her estate under IRC §§ 2033, 2035, 2036, 2038 or 2041.

(a) The IRS stated that, pursuant to the ruling in *Bosch*, it was to "apply what it finds to be state law after giving 'proper regard' to the state trial court's determination and to relevant rulings of other courts of the state. In this respect,

the [IRS] may be said, in effect, to be sitting as a state court." Because the ruling request represented to the IRS that the settlor had intended to relinquish her control over the trust assets, that distributions from the trust to her descendants were intended to be discretionary rather than mandatory, and that settlor intended her youngest child, not her youngest descendant, to have a power of appointment, the evidence clearly and unequivocally showed that the trust instrument did not express the true intent of the settlor and therefore the court order "correcting the scrivener's error [. . .] will be consistent with applicable State law, as applied by the highest court of State." Thus, the IRS concluded that the modification as requested would not cause inclusion under IRC §§ 2033, 2035, 2036, 2038 or 2041.

(b) The modification in PLR 200730015 was more akin to a reformation to correct a mistake under UTC §415 or 20 Pa. C.S. §7740.5 than a modification by consent under UTC §411(a) or 20 Pa. C.S. §7740.1(a). The ruling does not mention the UTC, and it is unknown if the state involved adopted the UTC.

3. In PLRs 200919008, 200919009 and 200919010, the IRS concluded that modification of an irrevocable trust did not cause estate tax inclusion IRC §2038 (which includes in a decedent's taxable estate property which is subject to alteration, amendment, revocation or termination by the decedent). The PLRs concerned modification of administrative provisions of trusts under a jurisdiction which has the UTC (the state is unknown, but the statute used to modify the trusts was similar to UTC 411(a) (modification upon consent of the settlor and all beneficiaries)).

(a) The IRS first concluded that the proposed modifications did not cause some or all of the property of the trusts to be included in the estate of any beneficiary of the trusts pursuant to IRC §§ 2035 through 2038 because the proposed modifications were administrative and not dispositive in nature; "[t]herefore, the proposed modifications will not cause . . . any beneficiary of a trust to be treated as making, or as having made, a transfer of trust property or an interest in any of the trust."

(b) The IRS next concluded that the settlor's consent to modify the trusts did not implicate IRC §2038, the IRS relied on Reg. §20.2038-1(a)(2), which provides that IRC §2038 does not apply "if the decedent's power [to revoke or

amend the trust] could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of parties under local law." Because the modifications were permitted under the state's version of UTC §411(a), and all parties consented to the modification, the IRS concluded that IRC §2038 did not apply.

(c) However, the IRS was not asked to decide (nor did it decide) whether the settlor's consent to modify the trusts implicated IRC §2036, which includes in a decedent's taxable estate property which the decedent may affect "(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, *either alone or in conjunction with any person*, to designate the persons who shall possess or enjoy the property or the income therefrom." IRC §2036(a) (emphasis added). PLRs 200919008, 200919009 and 200919010 concerned administrative modifications only, not dispositive modifications. The IRS has yet to rule on whether a settlor consenting to dispositive modifications may implicate IRC §2036.

(d) The IRS also determined that the modifications to the trusts did not cause the trusts (to which the settlor applied his GST exemption) to lose their statuses as GST tax exempt trusts based on the same reasoning as PLR 200822008, discussed below.

4. In PLR 200822008, the settlor of an inter vivos irrevocable "grantor" trust wanted a court to modify the terms of the trust and he sought rulings from the IRS that the modification would not (i) cause the value of the trust assets to be included in his estate, (ii) affect the GST inclusion ratio of the trust (this is discussed below), or (iii) affect the grantor trust status of the trust. As drafted, the trust provided that the trustee was prohibited from reimbursing the settlor for any income tax paid by the settlor on income earned by the trust. The settlor sought a court modification of the trust to provide the trustee with discretion, subject to the approval of a "Reimbursement Committee" (which must be comprised of persons who are not "related or subordinate" to the settlor within the meaning of §672(c) of the Code) and an adult child of the settlor who is an "adverse party" (within the meaning of § 672(c)) to reimburse the settlor for such tax.

(a) With respect to whether the modification would cause the value of the trust assets to be included in the settlor's estate,

the IRS considered whether the settlor would have the right to have the trust assets applied toward the discharge of his legal obligations, thereby causing inclusion under §2036. Citing Rev. Rul. 2004-64, the IRS stated that because any reimbursement to the settlor would require the exercise of the trustee's discretion and the approval of a Reimbursement Committee comprised solely of persons who are not related or subordinate to the settlor, the modification would not rise to the level of §2036 inclusion "regardless of whether or not the trustee actually reimburses [settlor] from Trust Assets for the amount of income tax [settlor] pays that is attributable to Trust's income." However, the IRS noted that the reimbursement modification combined with other facts (such as applicable local law subjecting the trust assets to the claims of the settlor's creditors) could result in estate tax inclusion under §2036. Note that although the IRS considered the end result of the modification (that is, the effect of the new trust provisions) in deciding whether there would be §2036 inclusion in the settlor's estate, the IRS did not consider whether the act of modification itself, such as under UTC §411(a) (modification of a trust with the settlor's consent), would result in §2036 inclusion.

(b) With respect to whether modification would affect the grantor trust status of the trust, the IRS stated "we see nothing in the proposed Reimbursement Provision that would jeopardize the Trust's status as a grantor trust, assuming it is a grantor trust. Rev. Rul. 2004-64 in no way indicates that as a result of the reimbursement provision in Situation 3, the trust fails to qualify as a grantor trust. In the analysis in Situation 3, the trust continues to be treated as a grantor trust despite the inclusion of the Reimbursement Provision."

5. There appears to be no guidance, however, as to whether a settlor's consenting to modify a trust could implicate IRC §2036. IRC §2036 includes in a decedent's taxable estate property which the decedent may affect "(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, *either alone or in conjunction with any person*, to designate the persons who shall possess or enjoy the property or the income therefrom." IRC §2036(a) (emphasis added).

6. To avoid the possible estate tax inclusion of a trust in the settlor's estate under IRC §2036, consideration should be made as to whether or not the trust should be modified under 20 Pa. C.S.

§7710.1 (without the settlor's consent but with the consent of all beneficiaries and trustees), even if the settlor is alive to avoid having the settlor consent to any modification.

7. For other PLRs examining modification of trusts and possible federal estate tax implications, *see* PLR 201132017; PLR 201131014; PLR 201128011; PLR 201128012; PLR 201128013; PLR 201128014; PLR 201128015; and PLR 201006005.

D. Gift Tax Concerns:

1. If a beneficiary of a trust gives up or reduces a right to income or principal of the trust by consenting to a modification, that beneficiary could be making a gift to the other beneficiaries of the trust. However, valuing any such "gifts" will often be difficult, if not impossible.

2. PLR 200917004 concerned dispositive modifications to a grandfathered GST exempt irrevocable trust where the settlor was deceased (it is unclear whether the state was a UTC jurisdiction). The trust specifically excluded adopted issue from the term "issue," and the trustee petitioned the court, with the consent of the beneficiaries, to modify the trust to include individuals legally adopted by settlor's issue by blood in the trust's definition of "issue." The court granted the requested modification.

(a) The IRS first noted that the modification did not shift a beneficial interest to a lower generation, and thus the modification to expand the definition of "issue" did not cause the trust to lose its grandfathered GST tax exempt status.

(b) The IRS then turned to the issue of whether the consenting beneficiaries made a taxable gift by consenting to the modification. By consenting to the modification to expand the definition of "issue," the issue related to the settlor by blood who were beneficiaries of the trust were reducing the amount of income and/or principal they could receive and therefore made a taxable gift to the adopted issue who were now beneficiaries pursuant to IRC §2501.

(c) ***Practice Tip:*** Based on PLR 200917004, practitioners must be extremely careful when modifying the dispositive provisions of a trust to avoid unintended gift tax consequences.

3. For other PLRs examining modification of trusts and possible federal gift tax implications, *see* PLR 201132017; PLR

201131014; PLR 201129013; PLR 201129014; PLR 201129015; PLR 201128011; PLR 201128012; PLR 201128013; PLR 201128014; PLR 201128015; PLR 201122007; PLR 201006005; PLR 200902009; and PLR 200231011.

E. GST Tax Concerns:

1. Treasury Regulations: Reg. §26.2601-1(b)(4), introduced in 2000, provides detailed examples of when modification might cause a GST exempt trust to become a GST nonexempt trust.

(a) Decanting or discretion to extend the time for vesting:

(i) Reg. §26.2601-1(b)(4)(A) discusses the possible GST consequences of decanting one trust into another trust or a trustee exercising the discretionary ability to extend the time for vesting in a continuing trust. In order for the new trust to be GST exempt or for a continuing GST exempt trust not to lose its GST exemption, either the terms of the trust must authorize the decanting or the extension of time for vesting in a continuing trust "*without* the consent or approval of any beneficiary or court" OR "*at 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 the court*[.]" Reg. §26.2601-1(b)(4)(i)(A)(1) (emphasis added).

(ii) In addition, the terms of the new trust (if decanted) or the continuing trust (if the trustee exercises the discretion to extend the time for vesting) cannot "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. For the purposes of this paragraph [. . .], the 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 be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period." Reg. §26.2601-1(b)(4)(A)(i)(2). This regulation creates a type of "federal perpetuities period." BNA Portfolio 850-2nd XI.J.3.a.

(b) Settlements: A "court approved settlement of a bona fide issue regarding the administration of a trust or the construction of terms of the [trust]" will not cause a GST exempt trust to lose its exempt status so long as (1) the settlement was a result of arm's length negotiations; and (2) the "settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolving the settlement." Reg. §26.2601-1(b)(4)(i)(B). The second requirement is consistent with *Comm'r v. Bosch*, 387 U.S. 456 (1966). Note that this section only covers judicial, not nonjudicial, settlements. Nonjudicial settlements are covered under Reg. §26.2601-1(b)(4)(i)(D) (covering other changes to GST exempt trusts).

(c) Judicial construction: "A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust [to lose its exempt status] if (1) [t]he judicial action involves a bona fide issue; and (2) [t]he construction is consistent with applicable state law that would be applied by the highest court of the state." Reg. §26.2601-1(b)(4)(i)(C).

(d) All other trust actions, including modification, division, combination and change of situs: Reg. §26.2601-1(b)(4)(i)(D) covers all other trust actions, including modification, division, combination, change of situs and "trustee distribution, settlement or construction that does not satisfy paragraph (b)(4)(i)(A), (B) or (C)" either by judicial action or nonjudicial action that is valid under applicable state law. §26.2601-1(b)(4)(i)(D)(i). In order for a GST exempt trust not to lose its exempt status under Reg. §26.2601-1(b)(4)(i)(D) (generally referred to in this section as "modification"), such modification cannot "shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not

extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust." §26.2601-1(b)(4)(i)(D)(1).

(i) Note that modification §26.2601-1(b)(4)(i)(D) requires that the time for vesting not be extended and that the interests not be shifted to a lower generation; otherwise, the trust will lose its exempt status. However, a trustee acting under §26.2601-1(b)(4)(i)(A) can extend the time in a which trust vests beyond the terms of the original trust for a certain time period (the "federal perpetuities period" as described above) and can shift beneficial interests to lower generations without causing a trust to lose its exempt status. If a trust is modified under §26.2601-1(b)(4)(i)(B) or (C), there are no time limitations at all, and there are no prohibitions against shifting beneficial interests to lower generations.

(ii) ***Practice Tip:*** Uncertainty is dangerous! If it cannot readily be determined whether or not a modification under §26.2601-1(b)(4)(i)(D) will shift beneficial interests to a lower generation so that the trust will lose its GST exemption, then such modification will be deemed to have shifted the interest so that the trust will lose its GST exemption. §26.2601-1(b)(4)(i)(D)(2).

(iii) An administrative modification that "only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust." §26.2601-1(b)(4)(i)(D)(2).

(iv) The ability under local law (such as a state's Principal and Income Act) to administer the trust "in conformance with local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust[.]" §26.2601-1(b)(4)(i)(D)(2).

(v) §26.2601-1(b)(4)(i)(E) provides examples concerning §26.2601-1(b)(4)(i)(A) through (D), addressing issues such as decanting, construction of ambiguous terms, division of trusts, combination of trusts, modification and change of situs. As described above, change of situs, is governed by the provisions in §26.2601-1(b)(4)(i)(D). Thus, if the transfer to another state will change the time for vesting "beyond the period prescribed under the terms of the original trust instrument, the trust would not retain exempt status." §26.2601-1(b)(4)(i)(E) Example 4.

2. As summarized above, in PLR 200822008, the settlor of an inter vivos irrevocable "grantor" trust wanted a court to modify the terms of the trust and he sought rulings from the IRS, including a ruling that the modification would not affect the GST inclusion ratio of the trust. With respect to whether modification would affect the GST inclusion ratio of the trust, the IRS acknowledged that "no guidance has been issued concerning the GST tax consequences of the modification of a trust created after September 25, 1985. At a minimum, a modification that does not affect the exempt status of a trust that is not subject to the GST tax because it was irrevocable on to [sic] September 25, 1985 similarly should not affect the inclusion ratio of the trust created after September 25, 1985." The IRS concluded that because the proposed modification did not shift an interest in the trust to any beneficiary that occupied a lower generation than the persons who already held a beneficial interest prior to the modification and because the modification did not extend the time for vesting any beneficial interest in the trust, the modification would not affect the inclusion ratio of the trust, just as the modification would not have caused a grandfathered GST exempt trust to lose its grandfathered status. What we can take away from this part of the PLR is that modification under the UTC will not affect the inclusion ratio of a non-grandfathered trust so long as precautions are taken along the same lines as those taken to protect a grandfathered GST exempt trust from losing its grandfathered status. *See* Treasury Decision 8912, 65 FR 79735-79740, Dec. 20, 2000 (issuing final regulations providing "guidance with respect to the type of trust modifications that will not affect the exempt status of a trust").

3. For other PLRs examining modification of trusts and possible GST tax implications, *see* PLR 201131014; PLR 201129021; PLR 201129013; PLR 201129014; PLR 201129015; PLR 201128011; PLR 201128012; PLR 201128013; PLR 201128014; PLR 201128015; PLR 201122007; PLR 201121007; PLR 201121008;

PLR 201121009; PLR 201121011; PLR 201006005; and PLR 200231011.

F. Income Tax Concerns:

1. It is possible that a beneficiary's consent to modify a trust could cause the beneficiary to be deemed to recognize capital gains personally if the modification materially changes the beneficiary's interest. In PLR 200231011, all beneficiaries entered into an agreement whereby the trust was modified, in part, to change the income beneficiary's income interest. The IRS treated the change in the beneficiary's income interest as a "sale or exchange," causing him to be deemed to have realized a gain as a result of the modification described as a "transaction."

2. For other PLRs examining modification of trusts and possible income tax consequences, *see* PLR 201131014; PLR 201129013; PLR 201129014; PLR 201128011; PLR 201128012; PLR 201128013; PLR 201128014; PLR 201128015; PLR 201129015; and PLR 201122007.