

Reviewing and Updating Old Trusts

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Southern Arizona Estate Planning Council

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America's population is aging and the Great Wealth Transfer is well under way. According to a 2021 research survey between now and 2045 baby boomers (born 1946 to 1964) will inherit \$4 Trillion, Generation X members (born 1965 to 1980) will inherit \$30 trillion, Millennials (born 1981-1996) are set to inherit \$27 trillion, and Generation Z (1997-2012) is set to inherit \$11 trillion. Source: Cerulli Associates, "The Cerulli Report: U.S. High-Net-Worth and Ultra-High-Net-Worth Markets 2021."

Much of this wealth transfer will occur utilizing trusts. Some of these trusts will distribute and terminate upon the death or deaths of the grantors. However, many will continue to hold assets and will remain in existence for decades. Indeed, Arizona law is very generous and A.R.S. § 14-2901 allows for an irrevocable trust to continue for five-hundred (500) years after its creation.

As we all know, the lifetime federal estate and gift tax exemption amount continues to rise. In 2025 the One Big Beautiful Bill Act (OBBBA) was signed into law. The federal lifetime estate and gift tax exemption is permanently set to \$15 million per individual, and it will be annually indexed for inflation thereafter. This "permanent" change replaces the scheduled 2026 sunset of the previous Tax Cuts and Jobs Act (TCJA) exemptions. Thus, it is important when planning with clients to go back and review old trusts to make sure we are not missing an opportunity to make important updates or changes.

The purpose of this presentation is to present and review a few common scenarios where we are faced with opportunities to make important updates. Here are a few scenarios where we might encounter and be able to fix issues with old trusts.

I. Scenario 1.

Strategies to avoid funding a bypass trust that is not needed after one settlor has died.

This one is extremely common. A married couple has created a revocable living trust. The revocable trust is an A-B trust and provides for the creation of a bypass trust and a survivors trust upon the death of the first spouse. The first spouse has recently passed. The surviving spouse has now come in to see you with questions. He or she has enough estate tax exemption and a small enough estate that there is a very low probability that the surviving settlor will have to pay estate tax at death. The surviving spouse really does not want to fund the bypass trust, and you agree that it is not necessary to fund the bypass trust for estate tax purposes.

A. Why did this scenario occur? This scenario likely occurred because an A-B trust was set up years ago when the exemption was much lower. This was not bad planning, it is just a product of ongoing changes in exemption amounts. The other possibility is that the client retained an estate planning attorney who prepares A-B trusts for all clients. Yes, there are a few attorneys out there that do not believe in no-split trusts. Either way, this arrangement was put in place, and the plan was never revised to eliminate the A-B set up.

B. Is there a fix? Maybe. Assuming the client is not so wealthy that it clearly makes sense to keep the bypass trust for estate tax purposes, they might consider how they get rid of the bypass trust. If the qualified beneficiaries are agreeable, then there are some options here. What can they do?

C. The fixes. The fixes in this case typically only work if the qualified beneficiaries of the bypass trust are willing to cooperate with the surviving spouse or are at least not hostile to the surviving spouse. If the qualified beneficiaries are difficult people, step-children, estranged children, or charities, there is a high likelihood that they may not want to work with the surviving spouse and we might be out of luck. It is even possible that a biological child with a good relationship with his or her parents could be skeptical of signing away rights. Maybe the child is concerned about his or her surviving parent getting remarried? Maybe the child is concerned that the surviving parent will become vulnerable and be connived into amended the trust? Any of these beneficiaries may want to force the surviving spouse to establish the bypass trust in order to protect his or her interest. But if the qualified beneficiaries are agreeable to working with the surviving spouse, here are our options.

1. **Do Nothing! Sit and Wait.** The first fix is to simply do nothing or “wait.” Most practitioners forget this option. We can let the trust continue on for now, as a single fully revocable trust for the survivor. If the qualified beneficiaries of the bypass trust want the bypass trust to be established, then we can establish the bypass trust at that later time. There is no rule or statute setting a time limit for establishing a bypass trust. Doing nothing can also allow us to hedge. By hedging we could go back several years later and establish the bypass trust in the event that the law changes and exemptions are dramatically lower. The I.R.S. is not likely to challenge a late funded bypass trust. The worst case scenario is that at some point a qualified beneficiary gets frustrated and demands that the bypass trust be funded or sues to force the survivor to fund the bypass trust. In theory, the beneficiary may be able to allege the trustee has breached a fiduciary duty by not acting and could ask that the trustee be removed. However, in the end, the client may end up very happy in not spending money to split the revocable trust and the client gets to “hedge” as time goes on. This may not be the BEST option for all clients due to the possibility that the trustee could get sued, but it is an option. If we choose this option, it is very important to advise the client of the possible drawbacks in that a beneficiary could demand the bypass trust be funded, or worse, sue to remove the surviving spouse as trustee of the bypass trust. Often times, if we chose this option, we will restate the survivors trust under the main revocable trust. The bypass trust will then not be funded and in effect, all of the assets of the trust are by default owned by the main trust or the survivors trust. This is a “no harm, no foul,” approach, that works when the amount of money involved is modest and the parties involved generally get along. By only amending the survivors trust, which owns all of the assets, nobody can accuse us of amending the main trust or the bypass trust.

2. Non-Judicial Settlement Agreement/Family Agreement Under A.R.S. § 14-10111. In the event that all of the qualified beneficiaries are in agreement, the most common solution in this scenario is to execute a non-judicial settlement agreement. If all of the signatories are family members, this agreement is commonly referred to as a “Family Agreement.” Specifically A.R.S. § 14-10111(A) and (B) provide that “interested persons may enter into a binding non-judicial settlement agreement with respect to any matter involving a trust ... 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.” A.R.S. § 14-10111 (C) provides some specific examples of topics which can be the subject of a non-judicial settlement agreement including

“direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power” and “the liability of a trustee for an action relating to the trust.” In accordance, an agreement not to fund a bypass trust appears to be a proper topic for a non-judicial settlement agreement. This agreement executed by all of the adult remainder beneficiaries and charities, with appropriate representation of any contingent and remote beneficiaries, should usually be sufficient under Arizona law to allow the surviving settlor to take the action not to fund or establish the bypass trust. In truly innocuous situations, a non-judicial settlement agreement can be a very simple way to formally document why a bypass trust was not funded. It is hard to imagine this would ever come under IRS scrutiny or cause a problem in that regard.

Of course, a non-judicial settlement agreement is not a perfect solution. If dissolved, the bypass trust does not come into existence, and the remaining survivors trust offers no creditor protection for the surviving settlor. This set-up also offers little to no protection for the remainder beneficiaries. If one wants to paint a worst-case-scenario, imagine you tell the client that we can get the qualified beneficiaries to all sign a non-judicial settlement agreement. You prepare the agreement, everyone signs, and then five years later the surviving spouse finds love at first sight and marries a new spouse twenty years younger. The surviving settlor then finds a new estate planning lawyer, and changes the survivor's trust to name the new spouse as sole beneficiary.

Might those remainder beneficiaries be annoyed and seek counsel to review their options? Might counsel for the beneficiaries explain that the qualified beneficiaries of the unfunded bypass trust might have been protected had they not agreed to the non-judicial settlement agreement? Finally, might they claim they had no idea what they were signing, a document that was prepared by a lawyer without them being represented?

Again, the non-judicial settlement agreement route is not perfect.

You could consider treating the document like a pre-marital agreement and having everyone retain counsel. However, if there are multiple qualified beneficiaries, it might be difficult to convince all of the qualified beneficiaries to spend the money to retain their own counsel to review the non-judicial settlement agreement.

If we are not going to have all of the qualified beneficiaries retain their own counsel but we still want some protection, another option is to have the surviving settlor sign a contract regarding wills under A.R.S. § 14-2514 whereby the surviving settlor agrees not to amend the estate plan in a manner which would reduce the share of any of the qualified beneficiaries.

3. Court Modifications. The next option here, and maybe the most fail proof option is to simply go to Court and have the Court approve the decision not to fund the bypass trust. The Arizona Trust Code provides us with at least two mechanisms that a Trustee can use to file a Petition not to fund the bypass trust. First, under A.R.S. § 14-10412(A), the Court may modify a trust because of unanticipated circumstances, specifically:

The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. To the extent practicable, the modification must be made in accordance with the settlor's probable intention.

A.R.S. § 14-10412(A).

Further, A.R.S. § 14-10416 provides a method to modify a trust for to achieve the settlors tax objectives as follows:

To achieve the settlor's tax objectives, the court may modify the terms of a trust in a manner that is not contrary to the settlor's probable intention. The court may provide that the modification has retroactive effect.

A.R.S. § 14-10416.

With proper notice and court approval, this more formal process is less subject to questioning by anyone, including the IRS or other beneficiaries.

The drawback here is that even if the process goes smoothly, the client will be required to wait months for the court process to conclude. That is not to mention the financial cost of going to court. A Petition needs to be drafted, the lawyer needs to

prepare for the hearing, the client needs to prepare for the hearing, and we need to actually attend the hearing.

The worst case scenario would occur if the Court rejects the Petition or if a beneficiary objects and we need to withdraw the Petition or proceed to a contested hearing.

4. Convince the Client to Fund the Bypass Trust to Preserve the Decedents GST Exemption or for Creditor Protection. In this scenario we are not worried about the client being a candidate to pay estate tax at least when taking into account both spouses exemption through portability. However, the client may be a candidate to pay Generation Skipping Tax. When thinking about A-B trust planning, it is easy to forget about Generating Skipping Tax (GST). By all means, if the clients estate is well under \$15 million then it likely makes no sense to fund the bypass trust based on today's laws. However, if the client will be reliant on portability to avoid estate taxes, then we might want to consider convincing the client to fund the bypass trust. The reason is that the deceased spouses GST exemption cannot be ported over to the surviving spouse. In accordance, if skip persons may someday benefit from the trust, it might make sense to fund the bypass trust so that we can utilize the deceased spouses GST exemption. If we fail to fund the bypass trust, we will lose the deceased spouses GST exemption. This issue may not come to roost for many years, however, at some point down the line this issue could become a problem if the survivor dies and only a portion of the survivors trust is GST exempt. Of course, if we fund the bypass trust for these purposes and we later find out we don't have an issue we could move to terminate the bypass trust, or we could decant and give the surviving spouse a general power of appointment over the bypass trust.

Last, we should also make sure to discuss creditors with the client. It may be a rare scenario where the surviving spouse has creditor concerns. However, if so, it may make sense to convince the clients to fund the bypass trust in order to protect those funds from the survivors creditors at some point down the line. Again, if the creditor concerns pass, we could always go back later and add a general power of appointment to the bypass trust or terminate the bypass trust.

II. Scenario 2

Strategies for dealing with an existing bypass trust that is no longer needed.

A married couple has created a revocable trust plan. The revocable trust is an A-B trust and provides for a bypass trust and a survivors trust. One settlor has died, and one settlor is still living. The surviving settlor is your client and is coming in to review the estate plan. The A-B split has occurred, so the bypass trust is in existence and has been funded. The surviving settlor only has only a limited power of appointment over the bypass trust. The surviving settlor has plenty of estate tax exemption and is not a candidate to pay estate tax even if the funds in the bypass trust are added to his or her estate. Can we do anything to achieve income tax benefits since estate tax avoidance is no longer the primary objective?

A. Why did this scenario occur? Just like before. This scenario likely occurred because an A-B trust was set up years ago when the exemption was much lower. This was not bad planning, it is just a product of the continual rise in estate tax exemption amounts. At the time the plan was created, and maybe even at the time the split occurred, the bypass trust was needed. The main trust has been split and we now have an existing survivors trust and bypass trust.

B. Is there a fix? Typically, yes.

C. The fixes.

1. **Termination of the bypass trust.** It is easy to immediately think of modifying the bypass trust. Indeed, if the bypass trust has a large balance then we probably will not be looking at outright terminating the bypass trust. However, if the bypass trust holds a relatively small amount of money, we might consider just terminating the bypass trust. If we want to terminate the bypass trust then we have two options. First, we could have all of the qualified beneficiaries sign a non-judicial settlement agreement under A.R.S. § 14-10111. In the non-judicial settlement agreement, the qualified beneficiaries would all agree to the termination of the bypass trust and to the disposition of the assets. The second option for terminating the bypass trust is to file a court Petition under A.R.S. §10412(A) requesting authorization to terminate the bypass trust because of unanticipated circumstances. The Court order would terminate the trust and may provide instructions on how to distribute the remaining principal.

2. **Adding a General Power of Appointment.** If we are no longer worried about estate tax, and we decide not to terminate the bypass trust, then instead we should be worried about improving the bypass trust and gaining income tax benefits. We can obtain the tax benefits of a step-up in cost basis if we give the surviving settlor a general power of appointment over the bypass trust. A general power of appointment is one that can be exercised in favor of the holder, the holder's estate, the holder's creditors, or the creditors of the holder's estate. We probably don't want to give the surviving settlor the ability to exercise the power in favor of himself or herself, his or her estate, or his or her present creditors. Instead, we are less likely to run into trouble if we add a power in favor of the creditors of the surviving settlor's estate.

We have a few options for adding the general power of appointment.

First, we could decant the bypass trust to add the general power of appointment under A.R.S. § 14-10819 if the bypass trust gives the trustee the discretion to distribute income or principal. If we decant, the trustee may want to consider obtaining a non-judicial settlement agreement wherein the qualified beneficiaries consent to the modification.

The second option is to take the matter to court, if you feel a court proceeding is worth it. We can go to court asking the court to modify a trust to add the general power of appointment. This option is safer than decanting. The petition to add the general power of appointment would be filed under A.R.S. § 14-10412(A) or A.R.S. § 14-10416. The court order would simply add a paragraph like the following:

The Trust is hereby amended to add the following:

Section 2.1: Surviving Settlor, Jane Doe, shall have the power to appoint the Trust to the creditors of her estate, by specifically referring to this power of appointment, exercisable only by her Will. To the extent this power of appointment is not effectively exercised, the Trust shall be distributed as set forth in Paragraph 3, below.

3. **Hedging with a Formula General Power of Appointment or by Adding a Trust Protector.** Why hedge in 2026? Well, in 2026, we finally have some clarity with regards to exemptions moving forward. The federal lifetime estate and gift tax

exemption is permanently set to \$15 million per individual, and it will be annually indexed for inflation thereafter.

However, even though we now have some immediate clarity, we need to be aware that this exemption amount could be changed by future laws.

In accordance, if the balance of the bypass trust is large enough, we might just want to hedge as much as possible.

The first option to hedge is to add a formula general power of appointment. This formula simply gives the surviving settlor a general power of appointment over as much of the bypass trust as is possible without exceeding the surviving settlors available estate tax exemption and causing estate tax to be due. In most scenarios, the entire bypass trust will be subject to the general power of appointment and will get the basis step up. In the worst case scenario, we will at least get a basis step up as to part of the bypass trust. A sample of a formula general power of appointment is as follows:

"Section 2.1: SURVIVING SETTLOR JANE DOE shall have the power to appoint the General Portion of the Trust solely to the creditors of her estate by specifically referring to this power of appointment. As to a fraction of the trust share denominated the "Limited Portion," she shall have no power of appointment over said portion.

The General Portion shall be the largest fraction of the bypass trust, if any, which if added to her "taxable estate" (determined initially as if no portion of this bypass trust was included in her estate) under 2001(a) (or applicable successor thereto, however denominated) of the Code, would not increase the amount of Federal Estate Taxes incurred at her death. In determining the fraction, the Trustee shall consider the credit for state death taxes only to the extent those taxes are not thereby incurred or increased and shall assume that none of the trust share qualifies for a Federal estate tax deduction. The Limited Portion shall be the remaining fraction of the bypass trust. "

There is really no downside to a formula general power of appointment unless we don't want to complicate the bypass trust or believe that in the future the IRS may challenge formula powers as a sham. Private Letter Rulings are not bind, but in 2022 a ruling was issued suggesting the IRS may approve of formula powers of appointment. See PLR 202206008.

The second way to hedge is to add a trust protector to the bypass trust. In Arizona, trust protectors are authorized by A.R.S. § 14-10818. The trust protector could be added through the use of decanting under A.R.S. § 14-10819 or could be added with a court proceeding brought under A.R.S. § 14-10412(A) or A.R.S. §10416.

Under A.R.S. § 14-10818(B) the trust protector has the powers granted to the trust protector by the trust instrument. These powers are not limited to but may include:

- 1. Remove and appoint a trustee.*
- 2. Modify or amend the trust instrument for any valid purpose or reason, including, without limitation, to achieve favorable tax status or to respond to changes in the internal revenue code or state law, or the rulings and regulations under that code or law.*
- 3. Increase, decrease, modify or restrict the interests of any beneficiary of the trust.*

A.R.S. § 14-10818(B).

The idea is that the trust instrument would name a trust protector for the bypass trust. The powers granted to the trust protector could be as limited as to allow the trust protector to modify the bypass trust to grant the surviving spouse a general power of appointment in favor of the creditors of his or her estate. We could also give the trust protector the ability to grant the surviving spouse with a formula general power of appointment as outlined above.

The use of a trust protector would allow us to “kick the can down the road” by giving someone the power to very quickly make a change when necessary in the future. There are, however, dangers associated with adding a trust protector. Might the person named die or become incapacitated? Might the person retire and be difficult to find? Might the person refuse to act or be too busy to act? Might the surviving spouse die unexpectedly?

Under A.R.S. § 14-10818 “except to the extent otherwise provided by the trust instrument, a trust protector is not a trustee or fiduciary and is not liable or accountable as a trustee or fiduciary because of an act or omission of the trust protector.” Despite this, if the trust protector is being paid only a nominal fee, a named trust protector may just simply decide they are too busy to get involved, or may just not feel like getting involved.

If any of these scenarios come to pass where a trust protector cannot or refuses to act, then we might be unable to act or left with a situation where we need to decant the

trust very quickly or get into court quickly. However, one possible solution is to not commit to naming one individual to serve as trust protector at this time. We would do that by adding language to the trust allowing a trust protector to be named at a later time. Here is a sample of some possible language:

During the lifetime of the Surviving Spouse, a majority of the adult Qualified Beneficiaries as defined under Arizona law (excluding the Surviving Spouse) may from time to time appoint (and remove and replace) an "Inclusion Trust Protector" with respect to the Family Trust, with a signed writing delivered to the Trustee. The Inclusion Trust Protector must be an attorney-at-law who is currently in good standing in the jurisdiction where he or she practices, and who is a Fellow of the American College of Trust and Estate Counsel.

The Inclusion Trust Protector's sole power shall be to amend the scope of the Surviving Spouse's Power to Appoint the Family Trust. The power to amend the scope of that Power of Appointment shall be to add, as a permissible appointee, the creditors of the Surviving Spouse's estate, or, if they have already been added as a permissible appointee, to remove and delete the creditors of the Surviving Spouse's estate as a permissible appointee. The purpose of such power is to give the Inclusion Trust Protector the ability to change whether or not the Family Trust will be included in the Surviving Spouse's estate for estate tax purposes under 2041 of the Code, and whether or not the assets in the Family Trust will be treated as "property acquired from the decedent" under Section 1014(b) of the Code.

The Inclusion Trust Protector's powers, notwithstanding A.R.S. 14-10818, shall be strictly and exclusively limited to those provided for under this Article. Any Inclusion Trust Protector acting hereunder, pursuant to Arizona law, is not a trustee or fiduciary and is not liable or accountable as a trustee or fiduciary because of an act or omission of the Inclusion Trust Protector when performing or failing to perform the duties of a Inclusion Trust Protector under the trust instrument, and shall be subject to the protections under A.R.S. 14-10818(D). The Inclusion Trust Protector shall be entitled to reasonable compensation for any action actually taken hereunder, as well as reimbursement for any expenses incurred in acting hereunder.

By not specifically naming a Trust Protector, there is no concern about liability for that person (even though Arizona statutes clearly protect such an individual, it's even more protected if there is no such position), but even more so, it avoids the difficulty of having to determine an appropriate independent third party when drafting the documents. We don't have to worry about a single human dying or becoming incapacitated and we don't have to worry about a firm being acquired or going out of business. By granting the power to appoint to the remainder beneficiaries, and having

the power be granted to the survivor, there is effectively little chance that either "side" is going to gain power over the trust in any manner which would impact the substance.

III. Scenario 3

Strategies for dealing with an old GST non-exempt trust containing a small balance.

A client comes in to see you. The client is updating his or her estate plan, but reminds you that he or she is the beneficiary of two continuing trusts set up by his or her parents. One trust is GST exempt. The other trust is relatively small, containing about \$200,000.00, but is GST non-exempt. The GST non-exempt trust provides that on the death of the client, the trust assets will be distributed outright to the client's children, the grandchildren of the settlors of the GST non-exempt trust. Generation Skipping Tax will be assessed on the GST non-exempt trust at the death of the client. Moreover, there will be no basis step up on the death of the client. The client is serving as his or her own trustee. What action can be taken on the GST non-exempt trust to Avoid Generation Skipping Tax being due on the death of the client?

A. Why did this scenario occur? Over the years the estate tax lifetime exemption amounts have increased. Likewise, lifetime generation skipping tax exemption amounts have increased. For example, as recent as 2002, the lifetime generation skipping tax exclusion was set at about \$1 million. In accordance, there are a number of irrevocable GST non-exempt trusts in existence today. Many of these trusts are just hiding in wait to trigger the Generation Skipping Tax upon the death of the present beneficiary.

B. Is there a fix? Maybe. The first impediment is whether or not we are going to court. If so, we could have problems with remainder beneficiaries. The other impediment is whether the client is acting as his or her own trustee. If the client is acting as his or her own trustee like in our scenario, then the changes are easier. If not, then we may have trouble convincing a third party trustee to take action.

C. The fixes.

1. Adding a General Power of Appointment. GST is a transfer tax that applies to various transfers to grandchildren and more remote descendants. It is intended to prevent the wealthiest families from forever avoiding estate tax, after the first generation, through continuing dynasty trusts that continue forever and, without the GST, would never again pay an estate tax again. GST is imposed when assets pass down to grandchildren or more remote descendants. Currently, each individual has a GST exemption equal to the Estate Tax exemption of \$15 million. Therefore, transfers in trust or directly to grandchildren up to that total generally won't incur this tax. As stated above, in the recent past, the GST exemption was only around \$1 million, and therefore there are "non-exempt" trusts out there far under the \$15 million threshold with potential GST issues.

The most simple fix to this issue is to either decant the trust under A.R.S. § 14-10819 or file a court proceeding under A.R.S. § 14-10412(A) or A.R.S. § 14-10416. The decant or court modification would amend the GST non-exempt trust and grant the

present beneficiary a power to appoint the trust in favor of the creditors of his or her estate. Upon the death of the present beneficiary, he or she will become the transferor for GST purposes, and there will be no Generation Skipping Tax due when he or she dies. If the client does not have enough assets to incur estate tax, then this “fix” will result in great benefits for the client. We will not pay Generation Skipping Tax, we will not pay Estate Tax, and we will even get a basis step-up on the death of the current beneficiary. Of course, if the current beneficiary is super wealthy, he or she cannot have this power without triggering an estate tax, meaning it's a wash with the Generation Skipping Tax. However, the Estate Tax would still trigger a step-up in cost basis you won't get with the just paying Generation Skipping Tax. So, even if the present beneficiary has a taxable estate, we may want to consider still making the modification. We are going to pay tax at death, but if we are going to pay tax, we might as well get the basis step up.

2. Hedging with A Formula General Power of Appointment. If the present beneficiary is not sure if he or she will have a taxable estate, or if we are simply uneasy about what the estate tax exception may be going forward, we might want to hedge. We can decant the trust under A.R.S. § 14-10819 or file a court proceeding under A.R.S. § 14-10412(A) or A.R.S. § 14-10416 to give the present beneficiary a formula general power of appointment. The result is that if the present beneficiary has any unused exemption at death, we won't waste that exemption. The formula would kick in to ensure that we pull in as much of the trust principal to the present beneficiary's estate as possible, without incurring estate tax. This method also gives us at least some benefit without fully committing to include the entire non-exempt trust in the present beneficiary's estate. Generally speaking, it seems that if we are going to pay tax, we may as well pay estate tax and get the basis step up, making this option less appealing. However, we could run into a situation where a client is just a bit uneasy, or maybe the client does not have the liquidity in his or her estate to pay the estate tax.

3. Just Terminate the Trust! If the GST non-exempt trust is small enough we might consider just terminating the trust. The negative to termination is that we would lose creditor protection, lose the ability to undo the transaction in the future, and likely need to go to court. If we are going to court, we would need to notify the qualified beneficiaries who in theory could object to the termination. However, if the trust is small enough, the client may simply want to go to court under A.R.S. § 10412(A) and ask the court to terminate the trust because of unanticipated circumstances. There could even be a small trust termination clause in the trust which we could invoke. The client would no longer have to deal with the headache of managing the trust and the client may save money each year not having to file tax returns for the trust. Sometimes there is added value in just simplifying an estate plan if complexity brings limited benefits.

4. Advise the Client to Spend This Money First. This action may be taken in conjunction with adding a general power of appointment or formula general power of

appointment. This is not mutually exclusive. However, if the client is younger, in good health, and planning on making any large purchases it might make sense to slowly drain the non-exempt trust instead of terminating the trust. The dangers is if we only tell the client to slowly drain the trust without taking any further action, the client could die unexpectedly and tax could be due. In theory, contingent beneficiaries could also complain about excessive withdrawals from the trust. However, this might be a good option for a client who is resistant to take action or pay the fees associated with taking action.

IV. Scenario 4.
Terminating an old QPRT that is no longer needed.

A client comes in to update his or her estate plan. As part of the consultation, the client tells you that several years ago the client set up a Qualified Personal Residence Trust (“QPRT”). The term of the QPRT has not yet expired. The client might have been a candidate to pay estate tax years ago, but under the current exemption amounts, the client is highly unlikely to pay estate tax. If the property passes to the remainder beneficiaries before the client dies, the property will not be in the clients estate at death, and no basis step up will occur. What action can be taken?

A. Why did this scenario occur? As stated above, as recent as 2002, we had a lifetime Estate Tax exemption as low as \$1 million. Even in 2009, the exemption sat at \$3.5 million. In accordance, less than 20 years ago many individuals were engaging in estate tax prevention planning that today is not necessary. A Qualified Personal Residence Trust (“QPRT”) is a Trust which allows you to transfer your home to your named beneficiaries (usually your children) at a future date, at a substantially reduced gift tax rate. Years ago, this was seen as a major positive and QPRT’s were common. Today, QPRTS are much less common with the increase in estate tax exemptions.

B. Is there a fix? Maybe. If the remainder beneficiaries of the QPRT are supportive then we can consider taking action. If the remainder beneficiaries are not supportive and want to see the trust reach its term, then we are most likely out of luck.

C. The fix. If we have support from the remainder beneficiaries then the course of action is to file a court proceeding under A.R.S. 14 §10412(A) and ask the court to terminate the trust because of unanticipated circumstances. The proceeding could also be filed under A.R.S. 14 §10416 which allows for modification to achieve tax objectives. There is no guarantee of success here, however, if the case is uncontested we have a high chance of success. In addition to the statutes authorizing modifications due to changed circumstances and to fulfill Settlor's tax objectives, there is an additional statute allowing us to modify the Trust based on consent. This is ARS 14 §10411. Therefore, to bolster the chance of success before a judge, you could add that and obtain consents for all the beneficiaries. The concern with an objective consent is it is more likely to be argued a taxable gift back to the Settlor, especially after CCA 202352018, from the remainder beneficiaries. If the entire family feels comfortable they are out of the transfer tax arena, this may be no issue at all, but it would be safest if this can be achieved without consent. But, if that's the only way to proceed, it may still be worth it. Our firm has had some judges refuse to order the modification without the consent of the beneficiaries, requiring us to go back and get it to get our favorable order.

If the judge signs off on the Court proceeding, we could then terminate the QPRT and return the property to the client from the trust. At the death of the client, the house will be included in his or her estate and will receive the basis step-up. If the house holds a low basis and several hundred thousand in gain, we could be looking at significant capital gains savings. So, here we

could be looking at a court proceeding that costs a few thousand dollars in order to save tens of thousands of dollars in capital gains. This is a very nice return for the client. Of course, if the estate tax exemptions are permanently lowered in the future this would be a bad outcome and so there is at least some risk involved here. Either way, the option of terminating the QPRT should be at least discussed and offered to the client based on present circumstances.

V. Scenario 5.

Updating a bypass trust so that it can deduct all income as DNI.

A new client comes into the office. The client reveals that his or her spouse has recently died and a bypass trust needs to be set up and funded. You review the terms of the bypass trust and you are concerned that the bypass trust may not be able to deduct certain accounting principal as Distributable Net Income (DNI) by distributing it out to the beneficiary. The income trapped in the bypass trust may be taxed at the higher trust rate and may be subject to the Net Investment Income Tax. What action should be take?

A. Why did this scenario occur? The bypass trust was likely drafted by someone who was more focused on estate tax than income tax. The prior estate planning attorney was not careful to include language in the bypass trust providing for income tax benefits. Estate tax benefits will occur, however, we also want to make sure we get the best income tax result that is possible.

B. Is there a fix? Yes.

C. The fix. For an income item to be eligible to be distributed to the beneficiary, it must be included as part of DNI. DNI acts as a ceiling for the amount a trust or estate can take as a distribution deduction and as a ceiling for the amount of income that the beneficiary is required to account for on their personal income tax return. Pursuant to Section 643(a) capital gains are generally excluded from DNI. Instead, capital gains are normally allocated to trust principal and, therefore, are taxed to the trust. However, 26 CFR § 1.643(a)-3(b) provides that capital gains can be part of DNI if the trust instrument allocates them to trust income and such allocation is allowed by applicable local law.

In Arizona, the Arizona Principal and Income Act, A.R.S. 14-7402(a)(1), provides that in allocating receipts and disbursements between principal and income the trustee shall follow the terms of the trust.

So, if your new client is serving as trustee of the bypass trust it would be beneficial to decant the bypass trust under A.R.S. § 14-10819 to add a tool within the trustee's powers to make appropriate adjustments with regards to capital gains. The following is an appropriate sample:

The Trustee may allocate realized short term or long term capital gains to trust income instead of corpus or principal for purposes of Section 643(a)(3) and (b) of the Code, in the Trustee's sole discretion.

Of course, if you choose to make the above changes, keep in mind to be careful where the determination of income versus principal could drastically alter the rights involved. For example, we might want to think twice in a scenario where a surviving spouse is entitled to income from a trust but is unable to access principal. Likewise, we might want to be careful if we have hostile contingent beneficiaries.

VI. Scenario 6.

Adding flexibility or restrictions to an existing A-B plan.

Married couple clients come in to see you and update their estate plan which has not been updated in several years. The clients have an old A-B Trust. The clients want to discuss the mechanics of the bypass trust and how it might be updated. They express that their feelings about their estate plan have changed. What questions might we ask and what suggestions might we offer?

A. How did this occur? This is another situation with an older trust document. The issue is the specific terms and details of the bypass trust. Does the survivor have too much/too little control and flexibility over the arrangement? The clients may have recently married when the trust was created. The clients were younger and the relationship between them may not have been as strong as it is now. Circumstances just change over time, both in law and in interpersonal relationships.

B. Is there a fix here? Most likely.

C. The fixes.

1. Amend or restate the bypass trust to make it completely flexible. In some cases clients may express that they completely trust each other and want the surviving spouse to have unfettered control over the trust. The idea is not to in any way “handcuff” or make the survivors life more difficult. If the clients are expressing complete trust in the other spouse and an interest in reducing restrictions, then we need a flexible bypass trust. A very broadly drafted bypass trust could let the surviving spouse be his or her own trustee, with a right to all of the income, and a right to distribute principal in the trustee's discretion for the survivor's health, education, maintenance and support, without considering any other resources or assets of the survivor. The survivor can have a power to appoint at his or her death in favor of any individual or charity in the whole world, only excluding the survivor's estate and creditors.

Not only does the survivor, as his or her own trustee, directly have the power to do pretty much anything he or she wants in spending the money, but the ability to exercise the special power of appointment and change the beneficiaries also cuts off anyone from being able to complain. For instance, if the remainder beneficiaries are the deceased spouse's children, and they start to complain about how the survivor, as trustee, is investing or spending the money, the survivor can exercise the power and completely cut those beneficiaries out, including their legal standing to argue about the current administration.

Such an arrangement may be "just right" if both spouses want the survivor to have unfettered power, and only want the bypass trust for the tax benefits and/or creditor protection.

2. Amend or restate the bypass trust to reduce or eliminate flexibility. By contrast, on the other side of the spectrum, we occasionally meet with clients who had a flexible setup and now because of changed circumstances are more worried about getting assets to their children. Maybe the relationship has become more strained and trust is not what it once was? Maybe one or both spouses have serious concerns that if he or she dies first the other spouse will quickly fall madly in love and get remarried. Either way, these scenarios call for setting up a more restrictive plan. In this case, the bypass trust could be drafted with a corporate trustee, or perhaps even worse for the survivor, the remainder beneficiaries, as the trustee or trustees. It could provide the survivor would only get income or principal if the trustee deems it appropriate in emergency situations, and only if the survivor has no other assets. The survivor may have NO power to appoint whatsoever. No limited power and no general power. In such a trust, the survivor would have no real control and very little practical benefits. It may also be that the original trust terms were not really reflective of the clients' situation, even at the time. Perhaps the two spouses have different children, but the original Trust, while having an "A-B" split, gave the survivor a power of appointment exercisable among ANY of either Settlor's children. Meaning, even with the A-B arrangement, the survivor could immediately exercise the irrevocable portion in the sole favor of his or her children.

3. Settle on something in between. We may want to draft a bypass trust so that it will not be included in the survivor's estate for estate tax purposes under its terms (no general power of appointment and an ascertainable standard included if self-trusted) but that will also qualify as a QTIP Trust. (all income must be distributed to the surviving spouse at least annually and no other beneficiaries than the spouse.) Keep in mind you won't actually accomplish BOTH, but the bypass trust will meet the qualifications for either one.

Subject to those terms, it can be drafted however the clients wish, in terms of whether or not it has a limited power of appointment and how broadly it is couched, what the standards for principal distributions are, and who the Trustee is. This Trust meets all of the following goals:

- i. As an irrevocable trust, deemed settled by someone else, the bypass trust is protected from the surviving spouse's legal creditors.
- ii. The bypass trust can be protected from the survivor getting remarried, losing it in a divorce, or leaving it to a new spouse, protecting both the survivor, and the remainder beneficiaries.

- iii. When the first spouse dies, the survivor will have to decide whether or not to take a QTIP marital deduction for the trust. If the survivor does not take that election, then the deceased spouse's estate tax exemption is applied to that bypass trust. It will not be taxed when the survivor dies, and it will also preserve the deceased spouse's GST exemption. True, it does not get a step-up when the survivor dies, so this will work better if the survivor has an estate tax issue at death. If the bypass trust is going to have a larger balance, this might be useful as opposed to relying purely on portability, because the preservation of the GST exemption could pay off for future generations.
- iv. If the survivor does take the QTIP election on the bypass trust, it does not use any of the deceased spouse's exemption but that exemption can be preserved with the 706 through portability. Because of the election, the assets will be included for estate tax purposes on the survivor's death, and therefore the assets in the bypass trust get the step-up in cost basis upon the death of the surviving spouse. However, a "reverse-QTIP" election will still allow the Trust to preserve the deceased spouse's GST exemption.

There is no right or wrong on this issue, but something a married couple must decide as to their wishes in a joint document.

VII. Scenario 7.

Adding a trust protector to an existing trust document to add flexibility.

Your clients come into the office to update their estate plan. The clients have an A-B revocable trust but are concerned about constant uncertainty and changes in the law. The clients further worry that they could become incapacitated and that there will be no easy or quick way to make necessary changes to their trust. They worry that the trustee could be required to file a costly court Petition to modify the trust. The clients express interest in adding flexibility to their trust. What might the clients consider?

A. How did this occur? Many older trusts, even trusts that are still revocable, predate available Arizona laws that allow for more flexibility. These available laws include Arizona's trust protector statute and decanting statute which were both enacted in the last 20 years.

B. Is there a fix? Definitely.

C. The fix. The most basic fix for a trust that is still revocable would be to consider amending or restating the revocable trust to include a trust protector under A.R.S. § 14-10818. As stated above, A.R.S. § 14-10818(B) provides that a trust protector has the powers granted to the trust protector by the trust instrument. These powers may include:

1. Remove and appoint a trustee.

2. Modify or amend the trust instrument for any valid purpose or reason, including, without limitation, to achieve favorable tax status or to respond to changes in the internal revenue code or state law, or the rulings and regulations under that code or law.

3. Increase, decrease, modify or restrict the interests of any beneficiary of the trust.

A.R.S. § 14-10818(B).

Clearly, the statute leaves open the possibility of giving the trust protector broad powers to ensure that the trust can adapt to changing circumstances. A brief list of possible trust protector powers could include:

1. Replacing the trustee or nominating a successor trustee.

2. Amending the trust agreement to achieve favorable tax status such as adding general power of appointment or formula general power of appointment.

3. Amending the trust due to changes in federal law, federal regulations, state law, or federal or state case law.
4. Fixing ambiguous language or drafting errors.
5. Approving distributions.
6. Adding or removing beneficiaries.

VIII. Scenario 8.

Updating an old trust to deal with current or future ownership of digital assets.

A new client comes to your office wanting to update her trust. The client has not updated the trust in several years. The client discusses her interest in digital assets. She then goes on to explain that she has acquired crypto currency and limited edition digital memorabilia. The client believes the assets may have significant value someday and wants to make sure these assets are handled smoothly at her death. What suggestions might you offer?

A. How did this occur? There have been major advances in technology over the last two decades. This includes a rise in the popularity of potentially valuable digital assets. Many clients created trusts before these assets became common. Most of these old trusts are still revocable but may not contain language expressly allowing the trustee to take possession, custody, or control over the assets. Arizona digital rights laws are less than ten years old, and most of us practitioners didn't start addressing them until a few years before that. In our defense, many of these concepts are insanely new.

B. Is there a fix? Maybe. This is a cutting edge area of the law which is not totally settled. At a minimum, there are some suggestions which we can make.

C. The fix. There may or may not be a "fix" here. However, there are at least two common sense suggestions which we can make.

1. Consider Naming a Special Co-Trustee for Digital Assets. As stated above, the field of digital assets is rapidly evolving and developing. Not every person who is qualified to serve as the general trustee of a trust will be qualified and equipped to collect and administer digital assets. Under A.R.S. § 14-10815 a settlor may confer powers on a trustee or co-trustee and may limit the powers of a trustee or co-trustee. In accordance, it might make sense in some situations to name a special co-trustee to administer digital assets. The special co-trustee would be a person or entity with more knowledge about collecting, controlling, and distributing or liquidating digital assets.

2. Put Cryptocurrency in a Custodial Wallet. Okay, this is not necessarily updating the terms of a trust, but it is updating the funding of an existing trust. Cryptocurrency can be titled in a custodial wallet or non-custodial wallet. If titled in a custodial wallet (with a custodian like Coinbase or Kraken), it is controlled by a third-party exchange (like a brokerage account for stocks), and the wallet can be titled in the name of a trust. If cryptocurrency assets are significant, it makes sense to move the currency to a custodial account where an executor can use established legal procedures to access funds (like accessing a stock account), rather than navigating complex, private-key recovery.

3. **Update the Trustee Powers.** In Arizona, A.R.S. § 14-10816 provides that a trustee has several enumerated powers. A.R.S. § 14-10816. None of these enumerated powers specifically reference digital assets. A.R.S. § 14-10815 further provides that a Trustee has “the powers conferred by the terms of the trust.” A.R.S. § 14-10815. Of course, someday when the settlor dies and the successor trustee needs to collect digital assets, we don’t want the successor trustee to get into a situation where he or she reviews the trust and realizes that the trust does not provide any specific powers related to digital assets. We want to make sure that we give the trustee specific enumerated powers to deal with digital assets. In accordance, it would be prudent to amend or restate the trust to include language governing digital assets. Some sample language is as follows:

The Trustee shall specifically also have all rights, powers, and authority to administer any and all “Digital Assets” which either Settlor holds. “Digital Assets” shall include, without limitation, the legal, practical, and technical authority to control or manage any and all personal electronic devices, online accounts, digital assets, and digital intellectual property. By way of illustration and not limitation, this shall include the rights to access and control any personal electronic devices, including computers, telephones, or any other device; social media profile or page which either Settlor owns, licenses, and/or controls; any and all electronic commerce sites, whether in the name of either Settlor or in the name of a company or d/b/a designation which either Settlor owns or controls; control and manage any loyalty program credits or awards, including airline miles, credit card awards, or any retail loyalty programs; control and manage any digital media accounts; control and manage any account holding crypto current or digital memorabilia any control and manage any offsite or other "cloud" storage of documents, files, computer backup, or digital information; any or all financial accounts either Settlor may have online, as well as access or control of any traditional financial accounts through electronic portals, including but not limited to any bank or brokerage company, electronic tax filings, utility accounts, loan or debt organization accounts, personal finance programs or any online financial accounts; control and manage any internet assets such as blogs or domain names; and, any and all accounts that Settlor has established with any online retailers or sellers of any sort whatsoever.

The Trustee shall have the right to retrieve passwords; edit or remove content; reset information; delete pages and/or profiles or other information; take action under any account or profile; transfer funds; withdraw and/or deposit money or other assets; and otherwise, without limitation, take absolutely any actions and have any powers that such Settlor would have had with respect to any Digital Assets. Any company managing such digital accounts is specifically authorized and directed to deal with The Trustee on either Settlor’s behalf.

The Settlers, pursuant to this power and this Agreement, hereby specifically assigns, effective upon each Settlor's death or incapacity, all of that Settlor's individually held rights to the trust estate held under this Agreement.

Arizona's Uniform Fiduciary Access to Digital Assets Act specifically applies to this Trust Agreement as set forth in A.R.S. § 14-13103(A)(4). Pursuant to A.R.S. § 14-13108, 14-13111, 14-13112, and 14-13113, a custodian of digital assets or electronic communications shall disclose to the Trustee any digital asset held in trust, including a catalogue of electronic communications of the Trustee and the content of electronic communications, whether or not the currently acting Trustee is the original user.

Pursuant to A.R.S. § 14-13115, the Trustee shall be an authorized user of the property of either Settlor, for the purpose of applicable computer-fraud and unauthorized-computer-access laws, including A.R.S. § 13-2316.