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IN PRACTICE

TRUSTS AND ESTATES

Building Flexibility Into Irrevocable Trusts

Making sure the trust is versatile enough to deal with the client's needs

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Irrevocable trusts are useful in many areas of estate planning. Clients often have concerns, however, about creating trusts that cannot be changed, concerns which are amplified given the current trend toward longer-term or multigenerational trusts. This article discusses ways to obtain flexibility with an irrevocable trust — including trust decanting — so that the trust is versatile enough to deal with a client's changed objectives or circumstances, whatever its duration.

Irrevocable trusts have many benefits and are commonly used. They typically allow an individual to remove assets, as well as the future appreciation of the assets, from his or her taxable estate. Irrevocable trusts can also provide protection against creditors.

Two common examples of irrevocable trusts are life insurance trusts and gifting trusts. The proceeds of a life insurance policy owned by an irrevocable insurance trust generally will not be included in the insured's taxable estate since he or she will not be the owner of the policy and his estate will not be the beneficiary. If the trust provides for the life insurance proceeds to be held in trust for the benefit of the spouse of the insured, the proceeds generally will not be subject to tax in the surviving spouse's estate either, even though the spouse may be acting as trustee and may make distributions to herself or himself for ascertainable standards. Therefore, the insurance proceeds can avoid estate taxation in both spouses' estates.

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An irrevocable gifting trust is commonly used to utilize annual exclusion gifts or larger gifts. Instead of gifting assets to an individual outright to reduce one's taxable estate, gifting trusts allow the donor to dictate the terms when a beneficiary receives full control of the assets, if ever. Gifting trusts can be structured as multigenerational trusts (a/k/a "dynasty trusts") that are intended to keep assets in trust for generations. These types of trusts can also be used to leverage Generation Skipping Transfer ("GST") tax exemptions.

Over time, however, circumstances may change and the terms of the irrevocable trust may no longer satisfy the client's objectives. The grantor of a trust may want to change beneficiaries, remove and replace trustees or successor trustees, or modify the time when a trust distribution is scheduled to be made to a beneficiary. For example, if a child of the grantor who was a minor when the irrevocable trust was created now has substance abuse or gambling problems, an outright distribution under the trust may no longer be appropriate. A grantor may also want to merge assets from two existing trusts to reduce administrative expenses or separate trust assets for GST tax-planning purposes. If a beneficiary has creditor problems, the grantor may want to add or modify a spendthrift provision. The grantor may also want to grant the trustee or another individual the ability to change the situs or governing law of the trust.

There are a number of ways to build flexibility into an irrevocable trust to permit these types of changes to be made.

Power in trustee to distribute insurance trust assets. An insurance trust may permit a trustee to distribute the trust assets (that is, the insurance policy and/or its cash value) out of the trust to a class of beneficiaries while the insured is alive. This provision can be very useful if the client wants to access the cash surrender value of the insurance policy owned by the trust during his or her life, or if the client wants to transfer the policy to a new trust. Practitioners should be careful when exercising this type of provision, however, as there may be gifting and fiduciary issues involved. For example, if assets are transferred to a beneficiary via this type of provision

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and the beneficiary subsequently distributes the assets to a new trust, the beneficiary's subsequent transfer could be a gift taxable event. In addition, beneficiaries who are adversely affected by a principal distribution may bring an action against the trustee for breach of fiduciary duty.

Limited power of appointment in beneficiaries. A provision granting a beneficiary a limited testamentary power of appointment allows that beneficiary to alter the terms of trust distributions to a specified class of beneficiaries without causing the assets to be included in the gross estate of the beneficiary who exercised the power. In a life insurance trust, for example, the insured's spouse may be granted a testamentary limited power to appoint the remaining trust assets among the grantor's issue, and thus dictate that the assets be distributed to the beneficiaries in a different manner or at a different time than is prescribed in the trust document. In the case of the child mentioned above who has an unexpected problem that an outright distribution would exacerbate, the limited power of appointment held by the spouse would be extremely useful to enable him or her to alter the distribution pattern. Since the power of appointment is limited to a defined class of beneficiaries, the power does not cause the assets to be included in the power holder's estate. If the power of appointment is not exercised, the assets would pass according to the trust terms. Including such a provision allows the surviving spouse to effectively change the terms of the children's trusts long after the irrevocable trust was created.

Power to change trust situs and/or governing law. It may be beneficial to move the trust situs to a state with favorable income tax laws to minimize the income tax liability on a trust's earnings or to avoid state income tax liability on the sale of an asset owned by the trust. Beneficiaries with creditor problems may also want to change the trust situs to a state with more favorable laws for protection against creditors.

Trust Protector. An independent party, often called a Trust Protector, may be granted several different powers under the trust, including the power to amend the trust to make technical changes to comply with changes in the law, to alter the administrative powers of the trustee, to name trust "investment advisors" and trust "distribution advisors" as permitted under the law of some states, and the power to remove and replace trustees or successor trustees. Appointing a Trust Protector is particularly important when establishing a multigenerational trust which in theory can last for centuries.

Trust decanting. Another way to achieve flexibility in an irrevocable is via trust "decanting," which means pouring assets out of an old trust and into a new trust with more favorable terms. New York was the first state to adopt a statute permitting trust decanting. Under the statute, EPTL section 10-6.6(b), (i) the trustee must have absolute discretion to invade the trust corpus, (ii) the exercise of such discretion cannot reduce any fixed income interest of any income beneficiary and must be in favor of the proper objects of the exercise of the power, (iii) the new trust cannot contain provisions deemed to violate public policy, and (iv) the exercise of the decanting power cannot violate the rule against perpetuities. If the statutory requirements are met, court approval is not necessary, and a trustee is permitted to pour assets into a new trust. The statute also provides specifics of the mechanics involved in exercising the decanting power, such as signing an instrument, filing it with the court and serving it on persons interested in the trust.

New Jersey has not passed a decanting statute. There is some authority permitting decanting, however, under the common law. *In Matter of Wiedenmayer* 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969), the court held that if a trustee has absolute and uncontrolled discretion to make distributions to a beneficiary, then the trustee is also permitted to pour the trust assets into a new trust. Whether a trustee can do so without court approval is not addressed in New Jersey case law, but it would be beneficial for a trustee to obtain court approval to protect the trustee from a later claim.

In the case of an irrevocable life insurance trust that provides for the proceeds to be distributed to the insured's child in an age 35 trust, where discretionary distributions can be made to the child for any reason before attaining age 35, at which time the remaining assets would be distributed outright, if the child has an unexpected problem before attaining age 35, trust decanting gives the trustee the opportunity to transfer the assets into a new trust with a different distribution pattern to better protect the beneficiary.

Trust decanting essentially allows an individual to modify an irrevocable trust. In doing so, however, advisors must be wary of potential tax consequences of such modifications, including violating a trust's GST tax-exempt status, and the potential gift tax consequences to a beneficiary who may have unexercised withdrawal rights under the existing trust.

Practitioners should consider incorporating these types of provisions in irrevocable trusts to maintain the utmost flexibility for the future. ■