Overcoming conflict, doubt and dissention:

Why an irrevocable trust is not always irrevocable

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As trust laws continue to evolve and modernize, beneficiaries often face a challenging dilemma – the trustee named in the trust deed has a lifelong position with no provision to remove him or her for any reason.

Situations sometimes arise where, over time, a later generation does not get along with a trustee appointed many years ago. The beneficiaries learn from their trust attorney that they are stuck with that trustee and have no options. Happily, many states today have adopted decanting statutes and have also provided for reformation of trusts.

The following gives a solid overview of what is involved in reforming a trust where a trust deed does not provide a mechanism for a change of trustee.

Reformation and decanting: When (and why) to change an irrevocable trust

In the trust world, irrevocable doesn't always mean irrevocable. Sometimes an irrevocable trust needs modification to improve the trust's administrative provisions, including replacing a trustee, clarifying or streamlining trustee succession, allowing a beneficiary to serve as trustee, moving trust situs (location) to or from another jurisdiction or terminating a small trust.

Trustees or beneficiaries also may wish to:

- change the governing law if the trust does not allow such a change
- take advantage of another state's favorable trust laws
- change dispositive provisions to make a distribution not clearly within the standard set forth in the trust
- adjust trustee powers
- adjust restrictions on beneficiaries
- benefit new, unanticipated beneficiaries
- modernize or update a trust
- divide a trust to separate generation-skipping transfer (GST) tax-exempt property from other property
- divide the trust into separate trusts
- consolidate trusts
- adjust trustee compensation provisions
- adjust outdated distribution caps or formulas to account for inflation and cost of living increases
- adjust antiquated social conventions (example: include adopted children or children born out of wedlock as beneficiaries)

Sometimes modification becomes necessary to achieve tax goals, such as to qualify for the marital deduction, obtain a charitable deduction, meet qualified domestic trust (QDOT) requirement or correct ambiguous or poorly drafted documents.

When (and how) to amend a trust: Reformation

Modification or amendment of an irrevocable trust is often referred to as "reformation." How and when reformation is permitted is a matter of state law. Trusts are often governed by a choice of law provision in the trust instrument, or if the trust instrument is silent as to governing law, the law where the trust is being administered is typically applied. If the trust being modified is governed by substantive law in one jurisdiction but is being administered in another jurisdiction, the procedural laws of the state of administration will typically apply.

Accordingly, for trusts administered in states with difficult trust laws or slow court systems, it is desirable to transfer trust situs to a jurisdiction where reformation is available and expedient under state procedural laws. In most cases, transfer of trust situs can be effected either by the trust instrument's terms or under the governing state law.

To achieve the desired result, the trust should be sitused in a jurisdiction with favorable trust laws. South Dakota is one such jurisdiction – where local law helps modify an irrevocable trust simply, quickly and cost effectively. South Dakota allows an irrevocable trust to be modified or terminated upon the consent of all the beneficiaries if the trust's continuance on its existing terms is not necessary to carry out a material purpose. An irrevocable trust may also be modified or terminated upon the consent of the grantor and all of the beneficiaries, regardless of the necessity of its material purpose.

The process is simple:

- Beneficiaries may consent to modification and termination if continuation is not necessary to carry out a material purpose of the trust.
- A written agreement among beneficiaries or written consents to a proposed modification or termination may be obtained to effect such reformation.
- All interested parties (i.e. the trustee and beneficiaries) may enter into an agreement setting forth the terms of the modification or termination of the trust in other situations.
- A written agreement among all interested parties or written consents to a proposed modification or termination should be obtained.
- Judicial approval is not required if all interested parties consent and if no interested party is unable to contract or is unable to consent through virtual representation.
- Even though court approval may not be required, it may be sought upon the petition of any interested party.

If a trust is so terminated, the trustee shall distribute the trust property in accordance with the grantor's probable intention or in any other manner as agreed by all the beneficiaries.

If the interested parties cannot agree on a method to reform the trust or the above provisions are not met, South Dakota law allows a grantor, trustee or beneficiary to petition the court to affirm a proposed modification or termination of a trust. If a beneficiary does not consent, the court may approve a requested modification or termination if the rights of the non-consenting beneficiaries are not significantly impaired or adversely affected.

A trustee or beneficiary may petition the court to modify the administrative or dispositive terms of the trust or terminate the trust if, because of circumstances not anticipated by the grantor, modification or termination of the trust would substantially further the grantor's purpose in creating the trust. A trustee or beneficiary may also petition the court for modification or termination of a non-charitable trust or appoint a new trustee if the court determines that the value of the trust property is insufficient to justify the cost of administration.

In such cases, the court must examine whether it's feasible to appoint a new trustee to continue the trust. On petition by a trustee or beneficiary, the court may reform the trust's terms to conform to the grantor's intention if failure to conform was due to a mistake of law or fact and the grantor's intent can be established. This law may also be used to achieve favorable tax objectives as long as the grantor's intent is not defeated.

South Dakota law allows a trustee to combine two or more trusts or divide a trust into two or more trusts if the combination or division does not impair any of the beneficiaries' rights or substantially affect the accomplishment of the trust purposes. On petition, the court may affirm or prevent a proposed combination or division, and, if the terms of the trust instruments creating the trusts are inconsistent, the court shall resolve such inconsistencies in its order by establishing the terms of the trust that will survive the combination or division.

The process for court approval is simple, cost effective and fast. Any trustee or beneficiary may petition for court supervision. Interested parties may also petition for the requested modification or for a court order or directions regarding any matter relevant to the administration of the trust.

Notice of the petition must be served on trustees, beneficiaries and attorneys of record, either personally or by mail, addressed to each at his or her last known address as shown by the records and files in the proceeding, at least 14 days prior to the hearing unless the court for good cause shown directs a shorter period. The court may allow service by publication (once a week for three weeks prior to the hearing in a legal newspaper in the county of the hearing) if the number or persons to be served and the expense involved would be burdensome. If all beneficiaries join in the petition in writing or waive notice and a hearing in writing, notice will not be required.

Any interested party may object to the petition. If such objections are brought, the court may order them to be filed and may adjourn the hearing and continue it to a contested calendar. The court may require or allow witnesses or production of evidence. If no objections are made, the court will typically grant the requested relief at the hearing.

Decanting

While reformation is a relatively easy way to modify an irrevocable trust, it does provide an avenue for disgruntled beneficiaries to object to the requested relief. Decanting, on the other hand, gives the trustee certain abilities to move the trust assets to a new trust at the trustee's discretion. If the criteria for decanting can be met, it is often the easier and simpler method to modify an irrevocable trust.

Decanting involves the idea that a trustee with authority to make discretionary distributions may appoint trust property in further trust instead of making distributions outright. A trustee may "decant" trust funds from one trust into a different trust. This principle existed at common law but has now been codified in South Dakota and certain other jurisdictions.

Decanting is appropriate where the trustee has discretionary authority and wishes to "pour" funds from one trust to another trust with terms more favorable for current needs. South Dakota allows a trustee with discretionary authority to make income and/or principal distributions to a beneficiary to instead exercise that authority by appointing all or part of the assets subject to that power to the trustee of a second trust.

Beneficiaries of the second trust must be either proper entities with the power to receive distributions, or one or more of those other beneficiaries of the first trust to or for whom a distribution of income or principal may be made in the future from the first trust at a time or upon the happening of an event specified under the first trust.

The second trust may, within certain limits, have different beneficiaries. For example, contingent beneficiaries of the first trust may be named as primary beneficiaries in the second trust.

South Dakota law also requires that the trustee take into account:

- the purposes of the first trust
- the terms and conditions of the second trust
- the consequences of the distribution

The trustee may wish to decant to a second trust to preserve or promote the grantor's primary purpose in establishing the first trust. If more drastic changes are desired, it may be advisable to seek reformation by beneficiary consent or court approval, as discussed above.

As it is authorized by statute, decanting does not require beneficiary consent or court approval. However, decanting must be done by an instrument in writing, signed and acknowledged by the trustee and filed with the records of the trust, and all beneficiaries of the first trust be notified in writing at least 20 days prior to decanting. Information in the notice must include a copy of the proposed decanting and a copy of the second trust. South Dakota further allows that, if all beneficiaries entitled to notice waive notice, the trustee may decant immediately.

Beneficiaries include anyone entitled to notice and a copy of the first trust. South Dakota's virtual representations apply to such notice requirements. Decanting may be applied to testamentary trusts or irrevocable inter-vivos (living) trusts.

There are some limits to decanting:

- It may not result in the reduction of a fixed income interest for which a marital deduction has been taken or to a charitable remainder trust or to a grantor-retained annuity trust.
- The power cannot be exercised to extend the IRC § 2503(c) vesting period.
- The power cannot be exercised over any portion of the trust to which a beneficiary has current withdrawal rights (i.e. Crummey rights or 5x5 powers).
- The terms of the trust must not prohibit exercise of the authority by a spendthrift clause or provision prohibiting amendment of the trust.
- South Dakota law also limits the power to decant unless held to an ascertainable standard if the trustee is also a beneficiary or if any beneficiary of the first trust has the right to change the trustees of the first trust.

Tax consequences

At any point when reformation or decanting is desired, it is important to consider whether the changes will be given effect by the IRS and whether there will be unintended or adverse tax effects. Income taxes arise where the property is being sold or exchanged for another asset. Issues related to decanting involve whether the new trust is the same as the old trust for income tax purposes. The new trust's distributable net income (DNI) would be shifted to the new trust, including capital gain.

Decanting may eliminate or create state or local taxation if the trust situs is changed. If less than the entire trust corpus is decanted, this may be the equivalent of a discretionary distribution by the trustee. Such distribution may carry out DNI to the beneficiary. The new trust should obtain its own taxpayer identification number unless it is a grantor trust.

Other taxes to consider are state, local and property taxes. When moving trusts from one jurisdiction to another or when changing applicable state law, these taxes may be avoided, decreased or increased, depending upon the facts of the situation. Readers are recommended to obtain their own tax advice as to reforming or decanting a trust.

Summary

Although beneficiaries often feel trapped with their current trustee due to a host of reasons, there are ways out.

When beneficiaries find that a real need arises to change a trustee, it is in their interest to consult with a competent trust and estate attorney to ensure that all avenues have been exhausted before deciding that it is not feasible to change the trustee. Many beneficiaries are reticent to hire legal counsel because they worry about running up legal fees. But the truth is, in states such as South Dakota, there are many well-regarded firms that are highly experienced at reforming and decanting trusts at fees that fall below those of large city law firms.

South Dakota's favorable reformation and decanting statutes also make the speed of decanting and reformation appealing to beneficiaries, even if a South Dakota court needs to get involved. A well-drafted trust deed today should provide a mechanism that can be used by the beneficiaries to change the trustee should the need arise.

In today's ever-changing world, it is imperative to maintain independence between the trustee, the investment advisor and the custodian to avoid any conflict of interest.

When considering any change to an irrevocable trust, we suggest you consult an attorney experienced in estate and trust law.

Two in a series of whitepapers presented by Sterling Trustees, an independent trust administration firm. Co-authored by Lindquist + Vennum, a large regional law firm with a focus on trusts and estates.

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