



ZEN AND THE ART OF TRUST MODIFICATION

National Association of Estate Planners & Councils

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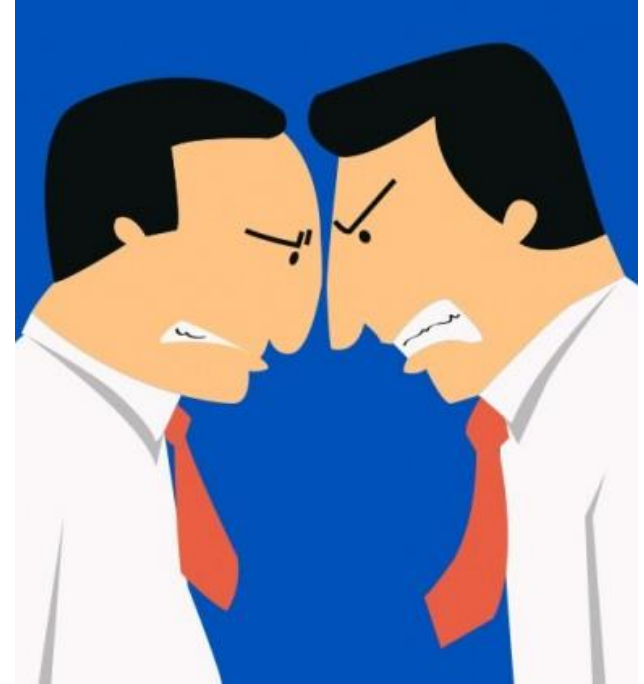
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“Peace of mind produces right values, right values produce right thoughts. Right thoughts produce right actions and right actions produce work which will be a material reflection for others to see of the serenity at the center of it all.”

Robert Pirsig, Zen and the Art of Motorcycle Maintenance: An Inquiry into Values

HOW DO YOU KNOW YOU NEED A MODIFICATION?

- ▶ Beneficiaries
 1. Beneficiaries are fighting
 2. A beneficiary has retained a lawyer
 3. Complaints about distributions, investments, expenses
 4. Beneficiaries won't sign approvals of accounts
- ▶ Trustees
 1. Co-trustees are fighting
 2. A co-trustee has retained a separate lawyer
 3. Distorted investments
 4. Noncompliance with terms of the trust
 5. Ambiguities
 6. Trustees are worried about fiduciary liability



COMMON REASONS FOR MODIFICATIONS

- ▶ **Administrative Change**
 - Investments
 - Trustees
 - Advisors
 - Information
- ▶ **Benefits**
 - Tax
 - Special Needs Trust
- ▶ **Construction**
- ▶ **Disputes or Dispositive Changes**

A *B*
C *D*

COMMON REASONS FOR MODIFICATIONS DISPOSITIVE CHANGES

- ▶ Eliminate Beneficiary
- ▶ Limit a Beneficiary's Rights
- ▶ Change a Beneficiary's Power of Appointment
- ▶ Create a Supplemental Needs Trust



COMMON REASONS FOR MODIFICATIONS TAX CHANGES

- ▶ Convert Non-Grantor Trust to Grantor Trust
- ▶ Convert Grantor Trust to Non-Grantor Trust
- ▶ Estate Tax Inclusion
- ▶ Tax Benefits



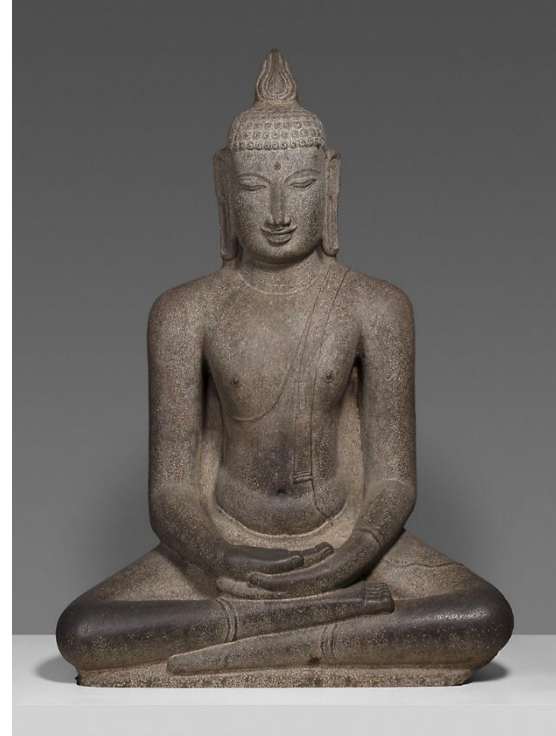
COMMON REASONS FOR MODIFICATIONS OTHER CHANGES

- ▶ Change Governing Law
- ▶ Severance
- ▶ Consolidation
- ▶ Add or Remove Spendthrift Provisions
- ▶ Expand Class of Measuring Lives



EVALUATING A PROPOSED MODIFICATION

- ▶ Why?
- ▶ What?
- ▶ Who?
- ▶ Where?
- ▶ Advocates and Opponents



EVALUATING A PROPOSED MODIFICATION, CONT.

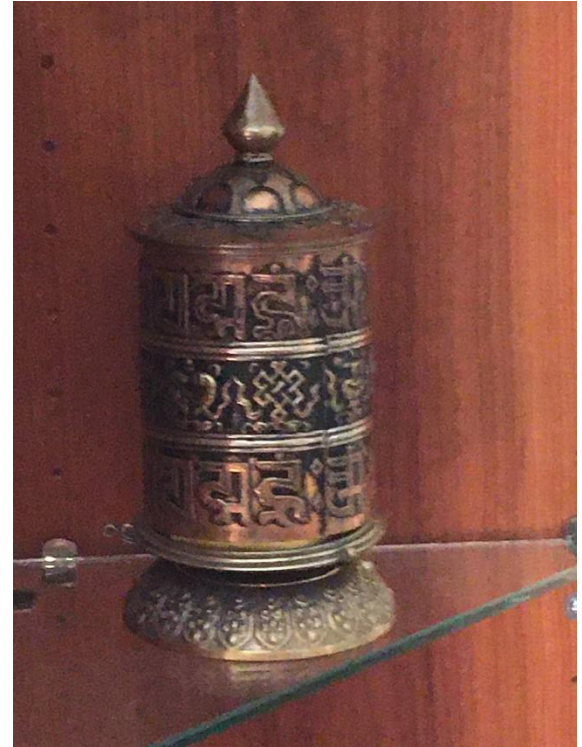
- ▶ Trust Instrument
 1. Trust Instrument
 2. Purposes
 3. Trust Modification Provisions
 4. Representation Provisions
 5. Trust Prohibitions



EVALUATING A PROPOSED MODIFICATION, CONT.

► Fiduciary Duties

1. Duty to Consider Purposes of Trust
2. Duty of Impartiality
3. Duty of Loyalty



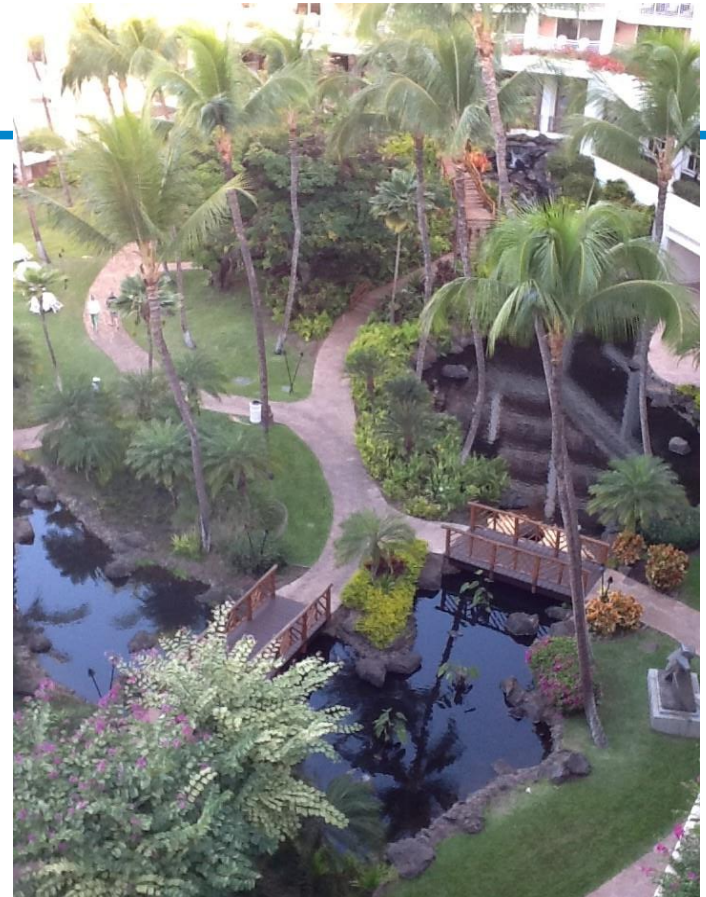
EVALUATING A PROPOSED MODIFICATION, CONT.

- ▶ Impact on Beneficial Interests
- ▶ Governing Law
- ▶ Taxes
- ▶ Fiduciaries
- ▶ Beneficiary Consent
- ▶ Notice
- ▶ Court Approval



TRUST MODIFICATION OPTIONS

- ▶ Actions Permitted Under Trust Instrument
- ▶ Severance and Consolidation
- ▶ Unitrust Conversions
- ▶ Principal and Income Adjustments
- ▶ Nonjudicial Settlement Agreements (“NJSA”)
- ▶ Decanting
- ▶ Judicial Modifications



SEVERANCE AND CONSOLIDATION (SECTION 417)

- ▶ Notice to qualified beneficiaries
- ▶ Cannot impair the rights of any beneficiary
- ▶ Cannot adversely affect the material purpose
- ▶ Terms and conditions must be substantially equivalent



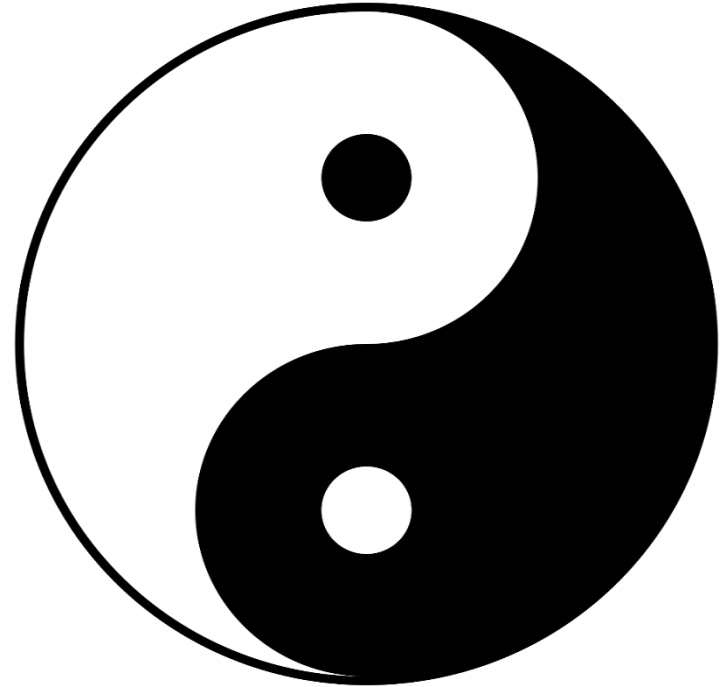
TOTAL RETURN TRUST CONVERSION

- ▶ Statutes
 - Conversion by Trustee
 - Conversion by Agreement
 - Court Conversion
- ▶ Unitrust Rate
- ▶ Valuation Rules
- ▶ Variations



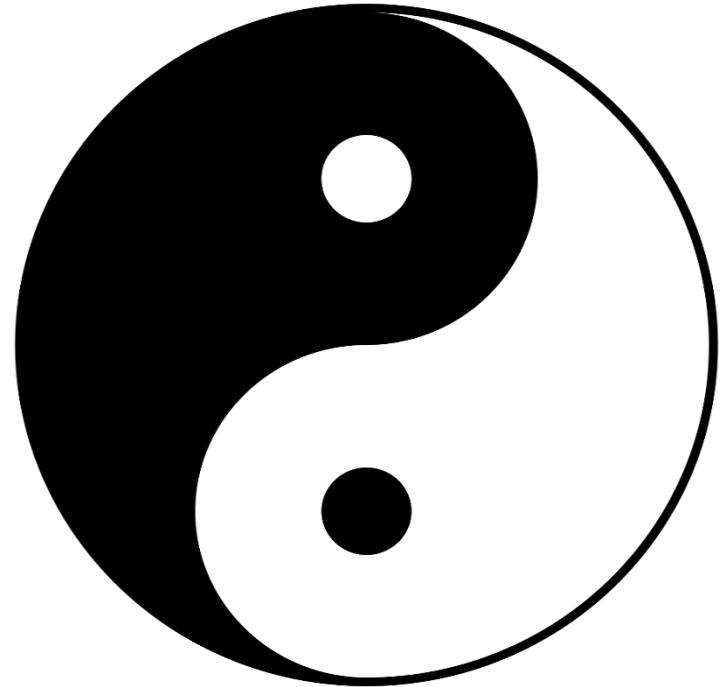
PRINCIPAL AND INCOME ACT: POWER TO ADJUST

- ▶ Uniform Principal and Income Act Requirements:
 - Investing as a prudent investor
 - Income Trust
 - Fiduciary Standard
- ▶ Considerations
- ▶ Restrictions



PRINCIPAL AND INCOME ACT: POWER TO ADJUST

- ▶ Considerations:
 - Settlor's intent
 - Beneficiary circumstances
 - Purpose of trust
 - Need for regularity of income
- ▶ Restrictions
 - Beneficiary/Trustee cannot adjust
 - No adjustments if tax benefit would be lost



NON-JUDICIAL SETTLEMENT AGREEMENTS (UTC § 111)

- ▶ Parties and Representation
- ▶ Any matter a court could address, including:
 - Construction
 - Trustee's Report
 - Grant of power or direction to act
 - Trusteeship
 - Trustee liability
 - Transfer of principal place of administration
- ▶ Cannot violate material purpose



NON-JUDICIAL SETTLEMENT AGREEMENT

STATE VARIATIONS

- ▶ Can instrument be modified?
- ▶ Material purpose limitation
- ▶ All matters a court could address?
- ▶ Additional matters that may be addressed:
 - Validity
 - Questions about trust property
 - Bona fide disputes
 - Changing law governing administration
 - Removal of trustee



DECANTING (UNIFORM TRUST DECANTING ACT)

- ▶ Decanting can sometimes be used to modify dispositive provisions.
- ▶ Decanting is a power exercised by the trustee.
- ▶ Beneficiary's role is limited.
- ▶ Trustee must have discretion to distribute principal.
- ▶ Trust instrument can restrict, eliminate or expand power of trustee to decant.



SCOPE

- ▶ Only irrevocable trusts
- ▶ Not wholly charitable trusts
- ▶ Trustee discretion usually required, usually over principal
- ▶ Trust can prohibit decanting in whole or in part

UTDA § 12: DECANTING POWER UNDER LIMITED DISTRIBUTIVE DISCRETION

- ▶ Authorized fiduciary who has limited distributive discretion over principal may decant
- ▶ “Limited distributive discretion” means an ascertainable standard or a reasonably definite standard
- ▶ Must grant each beneficiary of first trust beneficial interests in second trust that are “substantially similar”



UTDA § 11: DECANTING POWER UNDER EXPANDED DISTRIBUTIVE DISCRETION

- ▶ Can eliminate beneficiaries, but not add them.
- ▶ Can change distribution standard.
- ▶ Can eliminate or postpone future withdrawal rights.
- ▶ Can change future mandatory distribution rights.
- ▶ Can add or modify powers of appointment.
- ▶ Cannot eliminate a “vested interest.”

DECANTING: EXPANDED DISTRIBUTIVE DISCRETION

- ▶ Vested interest:
 - ▶ Right to mandatory distribution that is non-contingent
 - Current withdrawal right
 - Right is contingent if trustee has discretion to distribute principal to another beneficiary
 - ▶ Current right to mandatory distribution at least annually
 - ▶ True vested remainder



UTDA § 13: TRUST FOR BENEFICIARY WITH DISABILITY

- ▶ No discretion required in first trust
- ▶ The decanting must further the purposes of the first trust or the best interests of the beneficiary with a disability
- ▶ Only available in UTDA states and a few other states

DECANTING: RESTRICTIONS

- ▶ Tax savings provisions
- ▶ Rule against perpetuities
- ▶ Trustee compensation
- ▶ Trustee removers
- ▶ Trustee exculpation
- ▶ Protection of charitable interests



UTDA § 9: COURT INVOLVEMENT

- ▶ UTDA § 9 enumerates what a court can do
- ▶ Before a decanting:
 - Advise on validity of proposed decanting
 - Appoint special fiduciary
- ▶ After a decanting:
 - Approve decanting
 - Determine if attempted decanting is effective
 - Apply remedial provisions to flawed decanting



UTDA § 15: TRUST LIMITATION ON DECANTING

- ▶ Settlor may prohibit or restrict decanting
- ▶ Any restriction or prohibition must be carried over to second trust
- ▶ Decanting power still exists even if first trust provides an alternative method of modification



UTDA REASONABLE RELIANCE & SAVINGS PROVISIONS

- ▶ Reasonable reliance
- ▶ Savings Provision
 - Remedy for imperfect attempted decanting
 - Read out impermissible provision
 - Read in required provision
 - Fiduciary required to take corrective action
 - Court can decide on corrective action

JUDICIAL REFORMATION

- ▶ Modification or termination by consent
- ▶ Modification to achieve tax objectives or to correct mistakes
- ▶ Termination of small trusts
- ▶ Modification because of unanticipated circumstances



JUDICIAL MODIFICATION: MODIFICATION OR TERMINATION BY CONSENT (UTC § 412)

- ▶ A noncharitable trust may be terminated or modified by consent of the settlor and all beneficiaries.
 - May be exercised without judicial involvement.
 - Permitted even if conflict with material purpose.
- ▶ A noncharitable trust may be terminated upon consent of all beneficiaries if court determines continuance is not necessary to achieve a material purpose.
- ▶ May be able to modify or terminate even over beneficiary objection.

JUDICIAL MODIFICATION: UNANTICIPATED CIRCUMSTANCES (UTC § 412)

- ▶ A court may modify or terminate a trust if it will further the purposes of the trust.
- ▶ A court may modify administrative provisions if existing terms are impracticable, wasteful or impair the trust's administration.



JUDICIAL MODIFICATION: OTHER PROVISIONS

- ▶ Uneconomic trusts (Section 414).
- ▶ Mistakes (Section 415).
- ▶ Modification to achieve tax objectives (Section 416).
- ▶ Cy Pres (Section 413).

REPRESENTATION STATUTES

► UTC

- Section 302. Representation by Holder of General Testamentary Power of Appointment
- Section 303. Representation by Fiduciaries and Parents
- Section 304. Representation by Person Having Substantially Identical Interest

► State Variations

- Powers of appointment
- Designated representatives
- Class representation
- Priority of representation

TAX ISSUES – INCOME TAX

- ▶ Conversion of Grantor Trust to Non-Grantor Trust
- ▶ Conversion of Non-Grantor Trust to Grantor Trust
- ▶ Negative Basis Assets
- ▶ Beneficiary Recognition of Gain



TAX ISSUES – GIFT TAX

- ▶ Lapse of general power of appointment
- ▶ Trustee-beneficiary
- ▶ Beneficiary objection
- ▶ Beneficiary consent given, but not required
- ▶ Incomplete gift

TAX ISSUES – GENERATION-SKIPPING TRANSFER TAX

- ▶ Modification of grandfathered trusts or zero inclusion ratio trusts
- ▶ Safe Harbors
 - Governing instrument or state law permitted modification when trust became irrevocable
 - Court approved settlement of bona fide issue within the range of reasonable outcomes
 - No shift of beneficial interests downward
 - Safe harbors contain restrictions on changing rule against perpetuities or time for vesting

FURTHER GUIDANCE

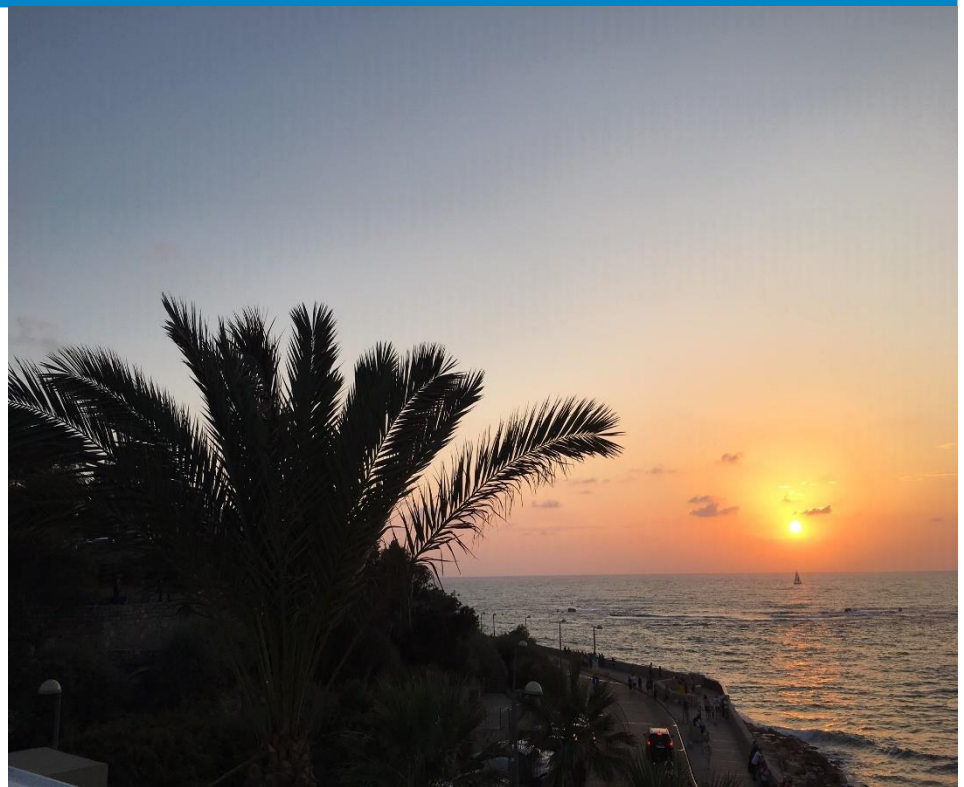
- ▶ Representation Rules: See questions A – I of Appendix I
- ▶ NJSAs: See questions J - M of Appendix I
- ▶ Decanting:
 - See list of state decanting statutes (Appendix II)
 - See my summaries of state decanting statutes (samples attached as Appendix III) at schiffhardin.com or actec.org
- ▶ Uniform Acts: uniformlaw.org, and don't forget the Comments

SUMMARY

- ▶ Administrative Changes: NJSA or decanting
- ▶ Benefits (tax or special needs trusts): Decanting or judicial
- ▶ Representation Rules: See questions A – I of Appendix I
- ▶ Construction: NJSA, decanting or judicial
- ▶ Disputes: NJSA (perhaps with decanting) or judicial
- ▶ Dispositive Changes: Decanting or judicial
- ▶ Disagreement between family lines: Severance (possibly with NJSA)
- ▶ Principal/Income Tension: Power to adjust or unitrust conversion

SUMMARY

- ▶ Read the trust
- ▶ Be mindful of material and other purposes
- ▶ Who must consent and representation issues
- ▶ Watch out for tax issues
- ▶ Fiduciary duties
- ▶ Fiduciary liabilities





QUESTIONS?

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