"THE ULTIMATE WORRIER" – WAYS TO PROTECT THE PLAN FROM CLIENT NEGLECT AND FAULTY MAINTENANCE

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Estate Planning Council of North Texas
March 18, 2020

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As a young attorney, a partner once told me that if you do not frequently wake up at night worried sick about technical issues, then you will never be an exceptional attorney. This presentation is for the truly exceptional attorney.

I. INTRODUCTION[1]

As attorneys, we thoughtfully design plans to facilitate our clients' unique objectives. Ideally, the client and his or her other advisors will in turn work to ensure the success of that planning. In a perfect world, the trustee will use the trust instrument as a road map for properly administering a trust and the client and his or her advisors will coordinate to ensure the correct tax reporting of trust contributions, income earned by trust property, distributions to beneficiaries, and transfers of property to successor trusts for future generations.

As a practical matter, we know that may not always happen as envisioned. Invariably, certain aspects of a trust's administration will be neglected by clients, misunderstood by other advisors, and sometimes purposefully undermined by beneficiaries and other third parties who prefer their objectives for a trust over those of the settlor.[2]

So what can we as attorneys do to help our clients better ensure that their wishes will be carried out? With the benefit of a crystal ball, a client might respond "please be my co-trustee!"[3]

While a client may avoid many of the missteps addressed in this presentation by engaging knowledgeable advisors to assist with implementing and overseeing the estate plan, others may be avoidable by the attorney's inclusion of preventative measures in the trust instrument or a complementary document. This presentation discusses those preventative measures and how they may be used to minimize or avoid altogether the damages that would otherwise result from the neglect of a trust's proper "care and feeding."

Generally, it is assumed the reader has a working knowledge of the issues addressed. However, in certain instances additional background reading is suggested in case the reader wishes to explore a topic in more depth.

II. ERROR-PROOFING SUGGESTION #1: SOLIDIFY DESIRED "GST TRUST" STATUS VIA IRC § 2632(C)(5) ELECTION

A. Anticipated Problem: Overreliance on Automatic Allocation Rules of IRC § 2632(c)(1) for Trust with "Hanging" Crummey Withdrawal Rights[4]

1. IRC § 2632(c)(1): Automatic Allocation Rules

A client creating dynastic trusts for descendants intended to be GST exempt may be reluctant to incur the cost of paying an advisor to prepare a United States Gift (and Generation-Skipping Transfer) Tax Return (a "Form 709") if the total contributions made during the year to each trust are equal to or less than the gift tax annual exclusion amount available to the donor with regard to the trust's current beneficiary given the ability to withdraw that amount under the trust instrument.[5] The client's perception that a Form 709 is unnecessary for such a year is likely to be reinforced if he or she has also been told by an advisor that his or her GST exemption will be automatically allocated to those contributions pursuant to IRC § 2632(c)(1) (the "Automatic Allocation Rules"). However, that advisor and the client should keep in mind that the Automatic Allocation Rules only apply **if** the trust qualifies as a "GST Trust" at the time of a contribution.

IRC § 2632(c)(3)(B) generally provides that a "GST Trust" is a trust with a realistic probability of facilitating a generation-skipping transfer with respect to its "transferor." Consequently, a GST Trust is the type of trust to which a settlor would generally want his or her GST exemption to be allocated as he or she makes contributions (or "indirect skips").

Correspondingly, IRC § 2632(c)(3)(B) generally excludes from the definition of "GST Trust" any trust whose corpus will be includible in the estate of a non-skip person (as defined in IRC § 2613(b)) via a partial or total termination or a withdrawal right or general power of appointment exercisable by him or her. In providing as such, IRC § 2632(c)(3)(B) prevents an automatic allocation of a settlor's GST exemption to a trust in circumstances in which such an allocation would generally be ill-advised. For example, IRC § 2632(c)(3)(B)(i) provides that a trust will not be a GST Trust if a beneficiary who is a non-skip person

[1] Generally, this outline attempts to guide the practitioner in ways in which to client-proof the maintenance of trusts, although certain of the suggested techniques may be more universally applicable.

[2] The terms "settlor" and "grantor" are used interchangeably throughout this outline as a reference to the creator of a trust.

[3] The author does not recommend this as a solution!

[4] All references to "IRC" in this outline are references to the Internal Revenue Code of 1986 (as amended).

[5] A withdrawal right of the nature described is conventionally referred to as a "Crummey Withdrawal Right" based upon the case establishing the concept of a withdrawal right qualifying an equivalent amount of a trust contribution for the gift tax annual exclusion amount under IRC § 2503(b). Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968). The gift tax annual exclusion amount is currently $15,000 but is subject to future inflation adjustments.

may withdraw more than 25% of the corpus prior to age 46.

As a caveat, IRC § 2632(c)(3)(B) provides that trust property will not be considered to be "includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) with respect to any transferor…" This provision provides both comfort and concern.

It provides that a beneficiary's ability via a Crummey Withdrawal Right to withdraw up to the then-applicable gift tax annual exclusion amount will be ignored in determining if the beneficiary's interests in the trust create a meaningful enough possibility of estate inclusion that the trust will not be considered a GST Trust subject to the Automatic Allocation Rules. However, that particular text in IRC § 2632(c)(3)(B) may effectively prevent a desired allocation of GST exemption from being quite as automatic as anticipated if a beneficiary is provided with Crummey Withdrawal Rights that "hang," as discussed in more detail below.

2. "Hanging" Crummey Withdrawal Rights

A more in depth examination of the tax consequences of Crummey Withdrawal Rights, particularly those that "hang," may be helpful in better understanding the risk of a settlor relying upon the Automatic Allocation Rules for securing a trust's desired GST exempt status.

a. "Crummey Withdrawal Rights"

A settlor will typically provide a trust beneficiary with a Crummey Withdrawal Right exercisable to withdraw an amount of a trust contribution equal to the lesser of (i) the contribution or (ii) the amount of the settlor's (and the settlor's spouse, if gift-splitting pursuant to IRC § 2513 is anticipated) otherwise unused gift tax annual exclusion amount applicable with regard to the beneficiary so that neither spouse will be required to use any of his or her combined gift and estate tax exemption amount on that portion of the gift.[6]

> **Example:** In 2020, Mother contributes $20,000 to Trust A and gives Child the ability to withdraw $15,000 of the contribution. Mother will be required to use only $5,000 of her combined gift and estate tax exemption amount on the gift, because $15,000 of her gift qualifies for the gift tax annual exclusion amount as a result of providing Child with a "Crummey Withdrawal Right" in the amount of $15,000.

b. Gift/Estate Tax Consequences of a "Crummey Withdrawal Right"

Under IRC § 2041, a currently exercisable withdrawal right will cause the assets that could be withdrawn by the beneficiary at death (or immediately prior thereto) pursuant to an exercise of that right to be included in the beneficiary's estate.[7] Consequently, a withdrawal right should only be exercisable for a limited period of time. The IRS generally considers 30 days to be a sufficient exercise period, provided the beneficiary is provided adequate notice of his/her withdrawal right.

To avoid an estate inclusion, care should be taken to ensure that a withdrawal right is eliminated as soon as possible in a manner that will not cause the beneficiary to be deemed to have made a gift to the trust. Under IRC § 2514(b), a release of a withdrawal right by a beneficiary will be deemed a transfer by the beneficiary to the trust of the amount of property that could have been withdrawn but for the release. In that event, the portion of the trust corpus ultimately attributable to the beneficiary's deemed transfer will be includible in the beneficiary's estate upon his/her death pursuant to IRC § 2036 (due to the beneficiary's eligibility for income distributions) and/or IRC § 2038 (if granted a power of appointment).

However, IRC § 2514(e) provides that the right to withdraw a certain amount of trust property may lapse upon the expiration of the exercise period without the beneficiary being deemed to have "released" the withdrawal right. That amount is the greater of (i) $5,000 or (ii) 5% of the trust's value at the time of the lapse (the "5/5 Amount").

Consequently, an irrevocable trust intended to be GST exempt will commonly provide for a staged lapsing of a Crummey Withdrawal Right (a "Hanging Crummey Withdrawal Right"), with an initial lapse of a portion of it after 30 days to the extent of the current 5/5 Amount and a gradual tax-free lapsing of the remaining exercisable withdrawal right that takes advantage of (i) the new 5/5 Amount provided to the beneficiary each January 1st and (ii) the potential for the trust's assets to appreciate sufficiently to make the second prong of the 5/5 Amount – or 5% of the trust's value – the operative "safe" lapsing amount. Effectively, the 5% prong becomes the operative prong once a trust has more than $100,000 in assets, because 5% of the trust's value will then exceed $5,000, or the first prong of the 5/5 Amount.

[6] Generally, it is assumed for purposes of this outline that a trust has only one current beneficiary and consequently is not a "pot" trust.

[7] However, as discussed above, that estate inclusion may be ignored in certain circumstances for purposes of determining if a trust is a "GST Trust" in accordance with IRC § 2632(c)(3)(B).

Example: Mom contributes $20,000 to Trust A in 2020 and gives Child the ability to withdraw $15,000 of the contribution for 30 days and provides for Child's withdrawal right to lapse at the end of the expiration period to the extent of the 5/5 Amount. Consequently, at the expiration of that 30-day period, Child will only have the continuing ability to withdraw $10,000 from Trust A (or $15,000 less $5,000, which is the lapsed amount).

Mom provides for Child's continuing ability to withdraw $10,000 (Child's "Hanging Crummey Withdrawal Right") to gradually lapse as Child receives a new 5/5 Amount each subsequent January 1st. Consequently, Child will only have the continuing ability to withdraw $5,000 after January 1, 2021, because Child's ability to withdraw $5,000 of the $10,000 previously subject to Child's withdrawal right may safely lapse as of January 1, 2021 due to the provision to Child of a new 5/5 Amount for 2021.

Child's right to withdraw the remaining $5,000 amount will lapse in its entirely on January 1, 2022 when Child receives a new 5/5 Amount for 2022.

The preceding assumes Trust A did not grow to exceed $100,000 while Child's withdrawal right remained exercisable and that no additional gifts to Trust A creating additional Crummey Withdrawal Rights occurred.

c. Hanging Crummey Withdrawal Right "Trap"

As previously noted, a trust is generally not a "GST Trust" if an appreciable amount of its corpus will be includible in the estate of a non-skip person via a partial or total termination or a withdrawal right or general power of appointment exercisable by him or her. As also previously noted, IRC § 2632(c)(3)(B) provides that trust property will not be considered to be "includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in section 2503(b) with respect to any transferor…"

What if a non-skip person possesses a currently exercisable Hanging Crummey Withdrawal Right that itself (or in combination with a newly-granted Crummey Withdrawal Right) gives him or her the ability to withdraw more than the gift tax annual exclusion amount? Could that Hanging Crummey Withdrawal Right disqualify the subject trust from being characterized as a "GST Trust" with regard to contributions made to it at that point? It seems so, which means a client should be advised not to rely upon the Automatic Allocation Rules with regard to a trust providing a beneficiary with a Hanging Crummey Withdrawal Right.

Example: In 2020, Mother transfers $15,000 to Trust A for the benefit of Child, who is age 30, with the remainder to Child's future descendants. Child is granted a Crummey Withdrawal Right with respect to the $15,000 contribution that will, if unexercised by Child, lapse after 30 days to the extent of the 5/5 Amount. Child decides to allow her Crummey Withdrawal Right to lapse in the manner directed by the trust instrument taking advantage of the 5/5 Amount. Because Child was granted a Crummey Withdrawal Right, the entire $15,000 contribution is covered by the gift tax annual exclusion. Mother does not file a Form 709 for 2020 because she did not make any other gifts that year and has no filing requirement. Consequently, no affirmative allocation of GST exemption was made. Because the amount subject to Child's Crummey Withdrawal Right is within the gift tax annual exclusion amount, the Automatic Allocation Rules apply and $15,000 of Mother's GST exemption is allocated as of the date of contribution to Mother's $15,000 2020 contribution to Trust A, resulting in a zero inclusion ratio for Trust A as of the date of contribution (i.e., Trust A is fully exempt from GST at the date of contribution). At the end of the 30-day period following Mother's gift to Trust A, Child's Crummey Withdrawal Right lapses in part in the amount of $5,000 (the applicable 5/5 Amount), and the remaining $10,000 "hangs."

In 2021, Mother makes another $15,000 transfer to Trust A. This transfer is covered by Child's gift tax annual exclusion, and so Mother does not file Form 709 as she is not required to do so. Because Child now has a withdrawal right as to the $15,000 contribution made in 2021 <u>and</u> the $10,000 "Hanging Crummey Withdrawal Right" carried forward from 2020, Child's total right of withdrawal is $25,000, which is greater than the gift tax annual exclusion amount. Consequently, Trust A arguably no longer qualifies as a GST Trust at the time of Mother's 2021 gift because Child (a nonskip person under the magical age of 46 for purposes of IRC § 2632(c)(3)(B)(i)) may withdraw more than 25% of the trust corpus via Child's ability to withdraw $25,000 of the $30,000 trust corpus.[8] Therefore, the Automatic Allocation Rules arguably do not apply to Mother's gift made to Trust A in 2021, and Trust A likely now has a partial inclusion ratio for GST tax purposes (i.e., it is likely now only partially exempt from GST) and will continue to have that partial inclusion ratio unless additional GST exemption is later allocated to Trust A by Mother or her executor (or under the default testamentary allocation rules of IRC § 2632(e) applicable at Mom's death) in an amount based upon date-of-allocation asset values necessary to restore Trust A's inclusion ratio to zero.[9]

B. Preemptive Planning

If a trust provides a beneficiary with a Hanging Crummey Withdrawal Right, counsel the client to file a Form 709 for the year of the initial trust contribution, even if no return is required to be filed because client's available gift tax annual exclusion amount for the beneficiary equals or exceeds the amount of the contribution. In the return, elect pursuant to IRC § 2632(c)(5) to treat the trust as a "GST Trust" with regard to the present and all future contributions. To make that election, an "x" should be made in Column C of Schedule A, Part 3 in the row in which a contribution to the subject trust is disclosed. A coordinating statement should then be attached to the Form 709 clearly indicating that an election is being made pursuant to IRC § 2632(c) to characterize the recipient trust as a "GST Trust" for purposes of the present trust contribution and all future contributions to it.

Note, each contributor to the subject trust (including the non-settlor spouse as a "deemed" contributor, if spouses elect to "gift-split") should follow these steps to elect into the Automatic Allocation Rules because an election pursuant IRC § 2632(c) will only impact contributions to the subject trust made by the individual making the election.

Sample Text:

IRC § 2632(c) Election to Treat the John Smith 2020 Family Trust as a "GST Trust"

Taxpayer hereby elects pursuant to IRC § 2632(c)(5)(A)(ii) to treat the John Smith 2020 Family Trust as a "GST Trust" (as defined in Internal Revenue Code Section § 2632(c)(3)(B)) so that the automatic allocation of generation-skipping transfer tax exemption rules of IRC § 2632(c) shall in any event apply with regard to (i) the transfers made by the Taxpayer in 2020 to such Trust and (ii) all future transfers to such Trust made by the Taxpayer (including those deemed made by Taxpayer pursuant to a future election to "gift-split" with the Taxpayer's spouse).

III. ERROR-PROOFING SUGGESTION #2: EXECUTION OF "BACKSTOP" PROSPECTIVE PARTITION AGREEMENT FOR IRREVOCABLE LIFE INSURANCE TRUST ("ILIT") BENEFITTING SPOUSE

A. Anticipated Problem: Spouses Will Inadvertently Contribute Community Property to a Spousal ILIT

A spouse who is the insured for a policy he or she intends to retain until death may wish to remove the proceeds from inclusion in his or her estate via a transfer of the policy to an ILIT benefiting the other spouse and/or descendants.[10] The transfer may be made to the ILIT either via a gift or a sale of the policy designed to avoid the three-year estate inclusion period imposed pursuant to IRC § 2035 with respect to a gift of the policy.[11]

For ease of discussion, assume the insured spouse is Husband and that he intends to gift the policy to the ILIT. If the policy is held by Husband and Wife as community property, they will need to convert the policy to Husband's separate property prior to his gift of it to the ILIT. Otherwise, a contribution of the policy as community property will cause half of the ILIT to be

[8] For ease of illustration, it is assumed the assets of Trust A have not appreciated since their contribution.

[9] Note, Mother also has the option of pursuing a late allocation of GST exemption based upon asset values as of the first day of the month in which the late allocation request is submitted. Treas. Reg. § 26.2642-2(a)(2). She may also want to explore seeking the IRS' blessing of a retroactive allocation of GST exemption based upon date-of-contribution values via a so-called "9100 relief" request.

[10] As discussed in more detail in section II of this outline, if the insured spouse intends the ILIT to facilitate a tax-free transfer of wealth to future generations and thus be GST exempt, he or she should consider making via a Form 709 filed for the year of the ILIT's creation an election pursuant to IRC § 2632(c)(5) to ensure the ILIT will be a "GST Trust" subject to the Automatic Allocation Rules in all events.

[11] In either event, the insured spouse will use his or her gift tax exemption in conjunction with his or her contribution to the ILIT of the policy or funds intended either to facilitate the ILIT's outright purchase of the policy or to serve as the "seed" amount substantiating the ILIT's ability to pay an installment note issued in conjunction with its purchase of the policy.

self-settled by Wife as of the contribution date, resulting in trust property being subject to her creditors' claims and more importantly inclusion in her estate at death.

For that same reason, Husband will need to contribute separate property funds periodically to facilitate the trustee's payment of premiums. Typically, the insured-spouse will not have sufficient separate property funds of his or her own for this purpose. Consequently, the spouses will need to partition community property funds to provide the insured-spouse with the necessary separate property funds.

B. Ideal Planning: Partition of Community Property Funds Via Agreement Executed Within Reasonable Time Prior to Contribution

Ideally, Husband and Wife will partition community property funds equal in amount to twice the premium due. Consequently, Husband will receive sufficient separate property to contribute to the ILIT to facilitate the trustee's payment of that premium, leaving Wife with an equivalent amount of partitioned separate property of her own that she may use in conjunction with her own gift planning (e.g., funding a spousal lifetime access trust (or a "SLAT") for Husband) or that she may simply keep as her own funds.[12] However, it is the rare client who wants and actually will reliably execute a timely partition agreement as premiums are due, particularly in light of the ability to set up premium payments for auto pay and consequently overlook the need to execute a corresponding partition agreement.

C. Preemptive Planning: Current Execution of "Backstop" Agreement Facilitating Prospective Partition of Community Property Funds

Given the possibility that Husband and Wife may neglect at some point to sign a partition agreement necessary to convert community property funds to Husband's separate property prior to contribution, how can the thoughtful planner assist spouses in facilitating timely partitioning of community property funds?

While it would be best practice for Husband and Wife to execute a partition agreement each time funds are to be subsequently contributed to an ILIT, the "Ultimate Worrier" may want to consider preparing as a "backstop" measure a "Prospective Partition Agreement" for Husband and Wife to sign (ideally, when the ILIT is created). In that document, Husband and Wife would agree to the following each year, subject to a revocation of the Agreement by either spouse upon (say) ten days' written notice delivered to the other: (i) effective January 1st, they will partition community property funds equal to <u>twice</u> the total premiums due for the year (as reflected in a premium schedule attached as an exhibit to the Prospective Partition Agreement) and set aside an equal share of those funds to each spouse as his or her separate property (providing that all accretions to, proceeds of and mutations in and income (whenever acquired) earned by the partitioned funds will also be the recipient spouse's separate property), and (ii) Husband will subsequently contribute funds partitioned to him in (i) to the ILIT to facilitate payment of the premiums due that year.[13]

Note, the Prospective Partition Agreement may be adaptable for other purposes. For example, it may be used to partition as of each January 1st community property funds equal to twice that year's inflation adjustment to the basic exclusion amount pursuant to IRC § 2010 so that one spouse may then contribute the funds partitioned to him or her as separate property to a SLAT previously created for the other spouse.

Of course, the Prospective Partition Agreement should contain all of the usual provisions recommended for a partition agreement (and transmutation agreement, if the suggestion in section III.D below is adopted).

[12] In theory, Husband and Wife should be able to partition community property funds and Wife then gift her resulting separate property funds to Husband for his contribution (together with his partitioned funds) to the ILIT whenever needed for premium payments. However, doing so could create the risk of the IRS challenging half of the contribution (i.e., the funds previously partitioned to Wife as her separate property) as effectively being contributed by Wife pursuant to the step transaction doctrine. If the IRS were to succeed in making that argument, as previously noted, the ILIT would be considered partially self-settled by Wife. For that reason, the better practice is as indicated.

Note, if spouses prefer to convert any funds acquired by Wife as her separate property back to community property, see a proposed plan for accomplishing that goal outlined in section III.D of this article.

[13] Again, it is best practice for the spouses to execute annually partition agreements (and subsequent transmutation agreements, if desired for the reasons discussed below) and rely upon the Prospective Partition Agreement solely as a "backstop" measure giving the spouses the ability to argue in good faith that funds were nevertheless partitioned as the settlor-spouse's separate property prior to contribution to the ILIT even if they ultimately neglect to execute a partition agreement in conjunction with a particular contribution.

Any income earned by the partitioned funds while held by Husband prior to their contribution to the ILIT (likely a nominal amount if held in a checking account) remaining as of December 31st of that year would be converted back to community property, if the planning proposed in section III.D of this outline is pursued by the spouses. Alternatively, the Prospective Partition Agreement could require Husband to contribute to the ILIT any income earned by the partitioned funds while held by him to avoid causing Husband to develop a separate property estate (albeit a modest one).

D. Additional Preemptive Planning: Incorporate in "Backstop" Prospective Partition Agreement a Prospective Transmutation of Partitioned Funds Back to Community Property

Spouses often prefer to own all property as community property, notably for the basis adjustment under IRC § 1014(b)(6) applicable for property held as community property at the first spouse's death. A community property-only marriage is a goal that will also greatly simplify matters for the executor of the estate of the first spouse to die when called upon to classify property for the probate inventory, funding bequests, and preparing an estate tax return (if necessary). Given that, consider providing in the Prospective Partition Agreement that funds previously partitioned January 1st not held on December 31st in an account designated in its titling as either Husband's or Wife's "Separate Property Account" (and thus reflecting his/her wish to preserve the funds' separate property nature) are to be converted back to community property if neither spouse has at that point revoked the Prospective Partition Agreement, which in that event will be deemed by its terms re-executed by Husband and Wife effective as of December 31st.[14]

Husband and Wife's agreement via a "re-executed" Prospective Partition Agreement to an annual December 31st conversion to community property of any remaining previously partitioned separate property arguably complies with the requirements under Chapter 4, Subchapter C of the Texas Family Code that the transmuted property be in existence and identifiable at the time of the conversion. While a transmutation agreement actually executed by Husband and Wife on December 31st may feel like a more faithful adherence to those statutory requirements, each spouse's awareness of his or her ability to revoke the Agreement but informed decision not to do so as of its deemed re-execution by them on December 31st arguably suffices to provide for the desired conversion of funds back to community property.

As a caveat, spouses typically agree in a partition or transmutation agreement that each of them and his or her personal representatives will execute additional instruments as necessary to carry out the intention of the agreement (the "Accommodation Provisions"). That commitment provides added assurance that the spouses' combined wealth will ultimately be divided in the desired manner between the spouses upon divorce or death, regardless of the marital property characterization of property during marriage. This could prove helpful for our situation if Wife has children from a prior marriage who might ultimately challenge the effectiveness of the annual December 31st transmutation and argue that all of the property partitioned under the Prospective Partition Agreement each January 1st to Wife remained her separate property at death.

In any event, the Prospective Partition Agreement and the community property presumption reflected in Texas Family Code Section 3.003 should enable the deceased spouse's executor to take the position that property partitioned to the deceased spouse in prior years had been converted back to community property prior to his or her death. As a caveat, any unconsumed partitioned property remaining from January 1st of the year of death would remain the deceased spouse's separate property unless he or she thoughtfully died on December 31st (but barring that "thoughtful" death would nevertheless be easily traceable as the deceased spouse's separate property).

IV. ERROR-PROOFING SUGGESTION #3: EXECUTION OF "BACKSTOP" PROSPECTIVE CONTRIBUTION NOTICES FOR ILIT

A. Anticipated Problem: Contribution Notices Will Not Be Sent to ILIT Beneficiaries

The settlor of an ILIT will typically want to qualify his or her trust contributions for the gift tax annual exclusion amount pursuant to IRC § 2503(b) to the greatest extent possible by giving each current beneficiary a Crummey Withdrawal Right.

The IRS takes the position that each beneficiary with a Crummey Withdrawal Right needs to be made aware of a contribution and the amount he or she may receive via an exercise of his or her withdrawal right within a reasonable time of the contribution in order to qualify an equivalent amount of the contribution for gift tax annual exclusion treatment.[15] While there is case law concluding that a beneficiary does not need to be aware of either the contribution or his or her withdrawable amount to secure the gift tax annual exclusion amount for the settlor, it is best practice to do so <u>in writing</u> given the relative ease with which a settlor can avoid an IRS challenge as a result.[16]

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[14] Note, this agreement will obviously in our example impact Wife more than Husband, who nevertheless could have some partitioned funds remaining as of December 31st if he does not ultimately contribute all of the funds set aside to him as separate property on January 1st to the ILIT (or if those funds earn income prior to Husband's contribution of the premium payment amount to the ILIT).

[15] Rev. Rul. 81-7, 1981-1 CB 474. Correspondingly, the IRS takes the position that a beneficiary cannot waive notice in that regard. I.R.S. Tech. Adv. Memo. 9532001 (Aug. 11, 1995).

[16] <u>Estate of Turner v. Comm'r</u>, TC Memo. 2011-209 (Aug. 30, 2011). It is also worth noting that in *Crummey*, the Ninth Circuit concluded that the beneficiaries' withdraw rights qualified trust contributions for the contributors' gift tax annual exclusion amounts, despite the Court's speculation that it was unlikely that the beneficiaries were aware of those

The settlor will almost invariably secure the desired gift tax annual exclusion treatment with the initial contribution to the ILIT of the insurance policy (or funds to facilitate the trustee's acquisition of a policy) because the attorney assisting the settlor in creating the ILIT will ensure the related gift notices will be prepared and executed. However, the settlor may be less attentive to that paperwork when left to his or her own devices as he or she makes additional contributions from year to year to facilitate the trustee's payment of insurance premiums.

Ideally, the settlor will notify the trustee in writing each time a contribution is made to the ILIT, and the trustee will in turn notify each beneficiary in writing of the contribution and the portion of the contributed amount subject to the beneficiary's withdrawal right.[17] While compliance with these procedures may have been a little cumbersome to navigate for settlors and trustees in prior years, they are certainly less so in the Digital Age, assuming the trust instrument permits written notices to be provided via electronic mail or even text messaging.[18] Nevertheless, this is an aspect of an ILIT's maintenance that is frequently neglected.

B. Preemptive Planning: Current Execution of "Backstop" Contribution Notice Providing One-Time Notice of Future Scheduled Contributions

Despite the relative ease with which the requisite notices to a trustee (from the settlor) and to beneficiaries (from the trustee) may be delivered, it is almost inevitable that a settlor will fail to notify the trustee of a contribution or that a trustee will neglect to notify a beneficiary with a withdrawal right (a "Withdrawal Beneficiary") that a contribution has occurred and the amount of such he or she may correspondingly withdraw. Given that, may a settlor as a "backstop" measure provide a trustee with advance notice of all future premiums due and corresponding contributions to be later made via a single written instrument? May a trustee in turn provide each Withdrawal Beneficiary with a similar notice that also includes the amount of each contribution subject to his or her withdrawal right (a "Backstop Contribution Notice")?

The IRS has informally approved of that approach in the context of an ILIT, which inherently accommodates a certain level of predictability with regard to the amounts and timing of future contributions.[19] In those instances, the IRS noted that the one-time document provided by the trustee to the beneficiaries was intended to provide "continuing notice" of future contributions to be made to facilitate the trustee's payment of premiums and thus reflected "the amount and premium due dates, the amount of the contribution, and the terms of withdrawal rights." Presumably, that one-time notice would only effectively provide the requisite notice of contributions and associated withdrawal rights so long as future contributions were made on or about the indicated dates. However, it reasons that the one-time notice would still provide the requisite notice of a contribution and associated withdrawal right, even if the contributed amount were ultimately less than previously indicated.

While those rulings analyze contributions to an insurance trust, presumably the settlor of any irrevocable trust could provide prospective notice of other future contributions to the trustee and the trustee could in turn provide prospective notice of those contributions and withdrawable amounts to Withdrawal Beneficiaries so long as the settlor is willing to commit to scheduled contributions.[20] To the extent the settlor diverted from a scheduled contribution date by more

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contributions and their ability to withdraw a portion of the contributed funds.

[17] Note, the Ninth Circuit in *Crummey* did not require notice of a contribution be given to a beneficiary with a withdrawal right, much less require that written notice be given. Interestingly, the IRS has never formally taken the position that written notice must be given either. Nevertheless, it is best practice for notice to be given and that it be in writing in order to substantiate to the IRS' satisfaction that the Service's (arguably) unnecessary requirement that notice of a contribution be given to a withdrawal beneficiary has been satisfied.

[18] See section VIII.B.2 of this outline for a more detailed discussion of this suggestion.

[19] See I.R.S. Priv. Ltr. Rul. 8121069 (Feb. 26, 1981) and I.R.S. Priv. Ltr. Rul. 8133070 (May 21, 1981).

[20] For example, the settlor could provide a Backstop Contribution Notice to the trustee in which he or she outlines his or her intention (but not obligation) to make annual exclusion gifts to trusts providing his or her children with Crummey Withdrawal Rights on January 1st of each year, and the trustee could in turn notify the children of the settlor's intentions. The settlor's proposed gifts should not be enforceable against the settlor unless the trustee or a beneficiary were to argue successfully for enforcement via promissory estoppel or another equitable basis (as discussed below, managing the beneficiaries' expectations in this regard in the Backstop Contribution Notice is advisable). As a caveat, because the inflation adjustment to the gift tax annual exclusion is generally unpredictable (and historically only occurs every three to four years), best practice would either be for the settlor and the trustee to "refresh" those notices as the annual exclusion amount is inflation adjusted or "overestimate" the amount of the gift tax annual exclusion in the Backstop Contribution Notice, as discussed below. While the "backstop" documents could theoretically define the contribution and withdrawal amounts by reference to IRC § 2503(b), the IRS might argue that doing so would provide inadequate notice to a Withdrawal Beneficiary of his or her rights (at least with regard to the inflation-adjusted amount) in that it would put him or her in a position of having to monitor inflation adjustments in order to determine the extent of those rights.

than a few days, the IRS should be expected to challenge the contribution as failing to qualify for the gift tax annual exclusion based upon the trustee's failure to provide the Withdrawal Beneficiaries with adequate notice of the contribution (unless notice of that contribution had been given by the trustee to the Withdrawal Beneficiaries at the time made).[21]

What if the amount the settlor ultimately contributes is greater than the scheduled amount, will the full amount qualify for the gift tax annual exclusion or only the scheduled amount? The IRS would likely take the position that only the scheduled amount qualifies for the annual exclusion amount. Consequently, it may therefore be prudent to err on the side of overestimating the amount of scheduled contributions. If so, consider managing beneficiary expectations by disclosing in the one-time notice that the indicated amount is the anticipated maximum amount of contribution but that the amount ultimately contributed may be less.

As a complementary backstop measure, it may be prudent to permit a Withdrawal Beneficiary to waive on a revocable basis the receipt of additional notices from the trustee of future contributions, so long as they are made in the amounts and at the times reflected in the Backstop Contribution Notice.

Note, the reliance of a settlor or trustee on the use of a prospective notice of contribution and associated withdrawal right or the reliance of a trustee on a Withdrawal Beneficiary's waiver of notice of future contributions should be specifically permitted under the terms of the trust instrument.

As previously noted, the courts have not required that the trustee provide notice of contributions to beneficiaries (if at all) in writing. However, it is best practice to do so because a written notice will undoubtedly be viewed more credibly by the IRS than assurances by the trustee that he or she provided verbal notice of a contribution and an associated withdrawal right. Of course, that does not necessarily mean that the trust instrument should require the trustee to provide the Withdrawal Beneficiary with written notice of contributions, given that a failure of the trustee to do so will almost certainly be seized upon by the IRS as grounds for disallowing the annual exclusion. Instead, consider permitting the trustee in the trust instrument to provide notices of contributions and withdrawal rights verbally, but counsel the trustee to give the notice in written form as best practice. Given that, it is recommended (as discussed in section VIII.B.2 of this outline) that the trust instrument specifically permit those notices to be delivered with relative ease via electronic mail or a text message. Of course, the trustee will want to save those communications for later provision to the IRS, if requested.

C. Additional Preemptive Planning: Miscellaneous Suggestions

1. <u>Withdrawal Beneficiaries May Acknowledge Receipt of Notice In Writing but Should Not Waive Exercise of Withdrawal Right</u>

While it may be prudent to have a Withdrawal Beneficiary sign in acknowledgment of his or her receipt of a contribution notice provided by the trustee, it is critical that the Withdrawal Beneficiary neither release nor waive his or her ability to withdraw part or all of the contributed property because a waiver will be deemed a release of a general power of appointment pursuant to IRC § 2514, which will in turn cause an estate inclusion due to the Withdrawal Beneficiary's eligibility for distributions and/or ability to exercise powers of appointment.[22] Consequently, if the trustee wants a Withdrawal Beneficiary to acknowledge receipt of a contribution notice to substantiate that the trustee has fulfilled his or her duties in that regard, the notice should indicate that the Withdrawal Beneficiary is signing strictly in acknowledgment of having received the notice and is not waiving the withdrawal right in any respect.

2. <u>Permit Exercised Crummey Withdrawal Rights to be Satisfied In Kind</u>

Because clients often wait until the deadline to pay a premium, the trust instrument should provide the trustee with the discretion to satisfy an exercised withdrawal right in cash or in kind (e.g., with a partial interest in the policy) so that there is no need for a trustee to wait out the exercise period for a withdrawal right before making the premium payment.

3. <u>Confirm Crummey Withdrawal Rights Exercisable With Regard to Indirect Gifts</u>

The Tax Court confirmed in *Estate of Turner* that the settlor's direct payment of premiums to the insurance company on behalf of the ILIT will be considered indirect gifts to the ILIT that may qualify for the gift tax annual exclusion amount to the extent the trust instrument provides the beneficiary with a corresponding right to withdraw an equivalent amount of trust property. By that same reasoning, an employer's payment of premiums for a group life insurance policy previously assigned to an ILIT should be considered

[21] It may be advisable to prepare a Backstop Contribution Notice from the settlor to the trustee and a similar notice from the trustee to each Withdrawal Beneficiary even if future contributions will be made arbitrarily by the settlor. While the IRS clearly would not respect the effectiveness of such a Backstop Contribution Notice based upon its current position, it may ultimately loosen its standards for notice in light of the reasoning in *Estate of Turner.*

[22] Treas. Reg. § 20.2041-3(d)(1). This issue is discussed in section II.A.2.b of this outline.

indirect gifts to the ILIT that via a beneficiary's withdrawal right qualify for the gift tax annual exclusion amount. While incorporation of the following text is crucial for an ILIT in the latter situation, it is also advisable to include the text in all insurance trusts given the likelihood that a settlor will forget to facilitate the trustee's payment of a premium via a trust contribution and will instead pay it directly to the insurance company:

> "During settlor's lifetime, settlor (and other parties) may make gifts of cash or other property to the trust (including indirect gifts, such as those effected by the payment of insurance premiums). Unless written instructions to the contrary are provided contemporaneously to the trustee by the contributor (or deemed contributor) of any such gift (or by the settlor, in conjunction with a third party's payment of a premium associated with a policy held by trustee), the following shall apply with respect to any such gift [add provisions regarding Crummey Withdrawal Rights.]

V. ERROR-PROOFING SUGGESTION #4: PROHIBIT UNDESIRED CONTRIBUTIONS IN TRUST INSTRUMENT AND ADDRESS INADVERTENT TRUSTEE ACCEPTANCES

A. Anticipated Problem: Trustee's Acceptance of Contributed Property of Nature Inconsistent with Intended Trust Benefits

Certain types of trusts by statute or regulation must prohibit any additional contributions beyond the initially contributed amount (e.g., grantor retained annuity trusts ("GRATs") and charitable lead annuity trusts ("CLATs")). Other types of trusts by statute or regulation must prohibit contributions of non-qualifying property (e.g., qualified personal residence trusts, or "QPRTs").

There are also trusts that will not achieve their desired benefits if the trustee accepts contributions of property from persons not intended to be contributors (e.g., the spouse who is the beneficiary of a SLAT, referenced in this outline as the "Beneficiary-Spouse"; the other spouse, the "Settlor-Spouse"). [23] While the governing instruments for those types of trusts are not required by statute or regulation to prohibit contributions of that nature, it may be best practice to do so to guard against an inadvertent contribution and thus preserve the trust's intended benefits.

B. Preemptive Planning: Prohibit Certain Contributions and Treat Trustee's Inadvertent Acceptance of Same as Demand Loan from Contributor

For example, it may appropriate to prohibit the trustee of a SLAT from accepting contributions of community property or the Beneficiary-Spouse's separate property because such a contribution will (as previously noted) cause the SLAT to be partially self-settled by the Beneficiary-Spouse, resulting in a portion of its assets being subject to the Beneficiary-Spouse's creditors' claims and inclusion in his or her estate at death.

But what if the SLAT instrument prohibits contributions by the Beneficiary-Spouse but the trustee nevertheless accepts a prohibited contribution of community property, or more precisely accepts <u>possession</u> of those funds? What are the tax and other legal consequences of the trustee's actions? Rather than create a situation in which we must necessarily debate those questions, the better practice would be to address the "acceptance" of a prohibited contribution in the trust instrument.

For example, the SLAT instrument arguably should provide in that event that the trustee is deemed to hold the "contributed" property subject to the Beneficiary-Spouse's and the Settlor-Spouse's discretion to require the return of the community property to either upon request.[24] In effect, each spouse will arguably be deemed to have entered as a lender into a demand loan with the trustee of the SLAT, which is almost certainly a grantor trust with respect to the Settlor-Spouse. If so, the Settlor-Spouse would be the deemed borrower for income tax purposes.

Note, while spouses can pursuant to IRC § 1041 engage in sales of property between themselves without recognizing capital gains, they cannot enter into an installment sale or a loan transaction without creating taxable interest to the lender-spouse (whether interest is stated in a note or deemed paid via IRC § 7872). Consequently, the Beneficiary-Spouse is deemed in our example to have entered into a demand loan with the Settlor-Spouse (as "owner" of the SLAT assets for income tax purposes) to the extent of the Beneficiary-Spouse's community property half of the "prohibited" contribution.[25] As such, the Settlor-Spouse, as "owner"

[23] See the discussion in section III.A of this outline.

[24] Thus, neither spouse will have made an irrevocable transfer to the SLAT and the Beneficiary-Spouse will therefore not have an estate inclusion issue under either IRC § 2036 or IRC § 2038. Note, it is unlikely that the spouses could take the position that the Settlor-Spouse irrevocably gifted his/her community property half but that the Beneficiary-Spouse merely loaned the trustee his or her half, due to the "cream in the coffee" concerns referenced in section VII.A.2 of this outline.

[25] Because an individual cannot loan money to himself or herself, there is no deemed loan by the Settlor-Spouse to himself or herself for income tax purposes.

of the SLAT's assets, will be deemed to owe annually taxable interest to the Beneficiary-Spouse pursuant to IRC § 7872 calculated at the short term applicable federal rate (or "AFR"). Depending upon the use of the funds acquired by the trustee via the "loan," the interest deemed paid may be deductible by the Settlor-Spouse as the deemed borrower (e.g., if the loan is deemed made for investment purposes). Certain exceptions to IRC §7872 apply that may prove useful, depending upon the amount of the deemed loan and the nature of the assets deemed acquired by the Settlor-Spouse via that "loan."[26]

VI. ERROR-PROOFING SUGGESTION #5: OUTLINE SETTLOR'S OBJECTIVES AND OTHER "NEED TO KNOW" ITEMS IN TRUST INSTRUMENT OR A TRUSTEE'S HANDBOOK

A. Anticipated Problem #5: Trustee's Confusion with Trust's Terms and Settlor's Objectives

The trust instrument will ideally serve as a road map for the trustee. However, the typical trust instrument is a lengthy document loaded with legalese that often creates confusion for the trustee and others in administering the trust, filing tax returns, etc.

B. Preemptive Planning: Outline Settlor's Objectives and Other "Need to Know" Items in Trust Instrument or a Trustee's Handbook

To make the trust instrument more navigable for the trustee and other advisors, it may be advisable to outline the key objectives for the trust and other "need to know" items in a "Material Purposes" article of the trust instrument or a special purpose exhibit to the trust instrument (if to be given legal effect) or a "Trustee's Manual" (if less formal guidance for the trustee is preferred). How that might be achieved in each of several contexts is discussed in more detail below.

1. <u>Specific Anticipated Problem: Confusion as to Trust's Intended Taxation</u>

a. Overview

A trust and its taxable income may be taxed in any number of ways. A trust can be created as or later become a complex trust, a simple trust, or a grantor trust (either with regard to its settlor via one or more of IRC §§ 673-677 or a beneficiary via IRC § 678 due to his or her presently exercisable or previously lapsed withdrawal right). A trust can toggle between or among the different classifications over the years, depending upon trustee appointments, distribution standards, and a myriad of other factors. If there are two or more settlors (or deemed settlors) to a trust, it could be a grantor trust as to each settlor to the extent of his or her contributed "portion" of the trust (with a settlor's "portion" later converting to a complex trust at his or her death, if not before).

Often times, it is difficult for a CPA or other third party to determine the intended tax status of a trust with a reasonable degree of ease. For example, a trust designed as an intentionally defective grantor trust or "IDGT" is often created as such via the settlor's retention of a so-called "swap power' described in IRC § 675(4)(C). However, planners who have historically used an alternative method of creating an IDGT may prefer to continue that practice, in which event the absence of the far more conventional swap power may cause a CPA to conclude mistakenly that the trust is a complex trust.[27]

Consider as well the increasing use of beneficiary defective inheritance trusts (or "BDITs") and beneficiary deemed owner trusts (or "BDOTs"), which are trusts designed to cause part or all of their taxable income to be taxed under IRC § 678 to a current beneficiary via a presently exercisable or a previously lapsed withdrawal right. While these types of trusts are gaining in popularity, they remain a mystery to many CPAs and thus create an additional potential for an incorrect reporting of trust income.

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[26] For additional guidance on these issues see Steve R. Akers and Philip J. Hayes, <u>Estate Planning Issues with Intra-Family Loans and Notes</u>, presented by Steve R. Akers to The University of Texas School of Law Continuing Legal Education 2012 Estate Planning Workshop, December 7, 2012. Note, payment of income taxes on the interest associated with the deemed demand loan is likely a better result than an estate inclusion of the portion of the SLAT that would otherwise be considered self-settled by the Beneficiary-Spouse.

[27] Until the issuance of Revenue Ruling 2008-22 and 2011-28, many planners were concerned that the use of a swap power could cause the trust's assets to be includible in the settlor's estate pursuant to IRC § 2036, IRC § 2038, and/or IRC § 2042. Via the Revenue Rulings, the IRS confirmed that incorporation of a swap power exercisable by the settlor will not cause an estate inclusion under any of those sections of the IRC. Consequently, it has become increasingly common to use a swap power reserved to the settlor to achieve a desired grantor trust status. However, some planners continue to use alternative means of achieving grantor trust status, likely due to habit more than a thoughtful objection to the use of a swap power (e.g., giving an independent trustee the ability to add charitable beneficiaries to the trust, resulting in grantor trust status pursuant to IRC § 674). Rev. Rul. 2008-22, 2008-1 C.B. 796 (Apr. 17, 2008); Rev. Rul. 2011-28, 2011-49 IRB 830 (Dec. 1, 2011).

b. Preemptive Planning: Clarify Intended Taxation in Trust Instrument

Given the potential for an incorrect reporting and payment of income taxes on a trust's taxable income, it is best practice for the drafter to address specifically in the trust instrument whether a trust is to be considered a complex trust, grantor trust (and whom is to be considered the "grantor" of the trust), or simple trust and under what (if any) circumstances that status is to change.[28] Along those same lines, consider clarifying other intended tax results for certain trusts (e.g., qualifying a trust for the marital deduction under IRC § 2056(b)(7) or securing the status of a "GST Trust" under IRC § 2632).[29]

2. <u>Specific Anticipated Problem: Trustee Confusion as to Settlor's Intentions for Distributions</u>

a. Overview

Typically, a trustee will be charged with distributing trust income and/or corpus to a beneficiary pursuant to a "health, education, maintenance, and support" standard (or a "HEMS" standard), although a purely discretionary distribution standard may also be used. Absent additional guidance from the settlor, the trustee may be inclined to take into account the trustee's own views on a beneficiary's behavior and other circumstances in evaluating distribution requests rather than be guided by what the settlor's wishes might otherwise be in that event.

b. Preemptive Planning: Clarify Settlor's Intentions for Distributions in Trust Instrument

Consider providing guidance regarding distributions to the trustee via a statement of the settlor's intentions for the trust and/or a summary of material purposes to be achieved by the trust incorporated in the trust instrument. While that guidance may alternatively be provided in a settlor's memo to the trustee, it will not be binding upon the trustee in that event.

Discuss with the settlor how he or she wants the trustee to evaluate distribution requests and exercise other discretions. Guide the settlor through that process by suggesting scenarios that may need to be addressed specifically in the trust instrument (e.g., a beneficiary's addiction issues). Consider developing with the settlor's input detailed guidance to the trustee in setting the distribution policy, which might entail requiring the trustee to consider one or more of the following factors: (i) the beneficiary's other resources, or perhaps only certain resources (e.g., liquid assets), (ii) a beneficiary's existing or potential future creditors' access to any distributed assets, (iii) whether a beneficiary and his or her spouse have a premarital agreement, and if not, the potential impact the marital property laws of the state in which the beneficiary and his or her spouse reside (or propose to reside) will have on the beneficiary's ownership of the distributed assets and income earned by those assets, (iv) whether the distributed trust assets will or are reasonably likely to result in the beneficiary having a taxable estate (or an increased taxable estate), (v) whether the beneficiary has or has had issues with substance abuse, criminal activity, or any other destructive behavioral issues and if the distributed assets are likely to facilitate that behavior and/or whether the beneficiary should be required to pass a drug test as a condition for receiving a distribution, and/or (vi) whether a payment to a third party on behalf of a beneficiary via a "facility of payment" clause might be more appropriate in light of one or more of the concerns noted above.

If the settlor wants the trustee to consider a beneficiary's own resources in determining whether to make a requested distribution, it may be appropriate to authorize the trustee to require the beneficiary to produce documentation reasonably relevant to that determination, including a current balance sheet, annual budget, or proof of annual income (e.g., a "W-2"). It may be appropriate to direct the trustee to assist (or arrange and pay for a third party to assist) the beneficiary in preparing the requested document, if he or she lacks the resources and ability to produce it on his or her own. If the beneficiary fails to produce (or cooperate in the preparation of) the requested documentation to the trustee's reasonable satisfaction, consider authorizing the trustee to withhold the proposed distribution until that requested documentation is provided.

3. <u>Specific Anticipated Problem: Trustee Will Overlook Important Deadlines</u>

a. Overview

There are a myriad of deadlines that a trustee of a trust will need to be mindful of in administering and ultimately winding up the trust (particularly a previously revocable trust), such as making the election under IRC § 645 for a "qualified revocable trust" or establishing new subtrusts to hold "S corp" stock after the applicable post-death grace period provided for pursuant to IRC § 1361 has expired.[30]

[28] As previously noted, grantor trust status will terminate upon the settlor's death.

[29] As discussed in section II.B of this outline, it is best practice to formally elect "GST Trust" status via an election pursuant to IRC § 2632(c)(5).

[30] The ultimate termination of all trusts under a trust instrument in compliance with the Rule Against Perpetuities is specifically discussed below.

b. Preemptive Planning: Provide Trustee with a Listing of Important Deadlines

Consider providing the trustee with a listing of important deadlines, both tax and nontax related. While those deadlines can be summarized in a separate "Trustee Manual," it may be more helpful to a trustee to incorporate them into the trust instrument itself in an article noting the importance of those deadlines (or an exhibit highlighting deadlines of note) so that the trustee will be able to work with the trust instrument as the sole governing document in administering the trusts.

4. Specific Anticipated Problem: Trustee Will Overlook Scheduled Trust Termination

a. Overview

In Texas and other states that still require trusts to comply with the Rule Against Perpetuities (or the "RAP"), there is a necessity of tracking the individuals who serve as the "measuring lives" for purposes of evaluating compliance with the RAP.[31] The RAP generally provides that all beneficial interests under a trust must necessarily vest before the twenty-first anniversary of the death of the survivor of the "measuring lives." The measuring lives must be individuals alive and identifiable at the time of the trust instrument's execution (or the settlor's later death, if the governing document is a revocable trust agreement or will).

If the instrument is silent as to the identity of those individuals, they will generally be persons with impactful relationships to the trust (e.g., the settlor and initial beneficiaries). More commonly though the individuals who are to serve as the "measuring lives" for a trust will be listed by name or description (e.g., "settlor's then living descendants") in the trust instrument in a "savings clause" designed to ensure compliance with the RAP. That clause will typically direct the termination of all trusts in existence under the trust instrument upon the twenty-first anniversary of the death of the survivor of the referenced individuals and the distribution of the corpus of the terminated trust on hand at that time to the current beneficiary (or if more than one, in the manner directed by the trust instrument, whether in designated shares or at the discretion of the trustee).

While typically that group of "measuring lives" will include the settlor and settlor's spouse and descendants, it is common for settlor's extended family members to be included as well to increase the likelihood of there being a centenarian or two in the group who will consequently extend the permitted duration of the trusts. In keeping with that goal, it is not uncommon to further expand the list of individuals in the "measuring lives" group to include persons without any discernable relationship to the trust but whose identities and dates of death are easily verifiable (e.g., descendants of His Majesty King George V of England living at the time of the trust instrument's execution).

The RAP requires only that all interests in a trust vest upon the 21st anniversary of the death of the survivor of the measuring lives. However, as previously noted, typically a trust will provide for its complete termination at that point and a resulting distribution of its assets to the current beneficiary or beneficiaries.

The pre-termination taxable income earned by the distributed assets in the year of termination (including capital gains actually distributed to the beneficiary) will be "carried out" and taxable to the beneficiary as distributable net income (or "DNI") pursuant to IRC § 661, as will the income earned by the distributed assets going forward due to the beneficiary's direct ownership of those assets.[32] The beneficiary/beneficiaries become the owner(s) of the trust property in all other respects as well. Depending upon the applicable state law, the income earned by those assets may be partially or entirely subject to division in the event of the beneficiary's divorce (e.g., if the beneficiary lives in Texas), will almost certainly be subject to the beneficiary's creditors' claims, and if retained will ultimately be includible in the beneficiary's taxable estate (if applicable). Distributed assets owned by the beneficiary should also be disclosed in schedules to a premarital (or post-marital) agreement, applications for student loans and mortgages, etc.

Those same consequences will generally apply even if the trustee "misses" the trust's termination and mistakenly retains the assets in trust. While an inadvertent retention of trust assets by the trustee in that event may for many purposes prove to be a "victimless crime," it could also cause meaningfully unfortunate consequences to the unaware beneficiary. For example, if a beneficiary is not aware that the assets still held in trust legally belong to him or her, the beneficiary will fail to report those assets and notably the income earned by the assets as belonging to him or her for tax and other purposes (e.g., on asset schedules to a premarital or post-marital agreement).[33]

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[31] Note, certain states that have abolished the RAP still measure a trust's permitted duration or permitted limitations on the absolute power of alienation of property by reference to "lives in being."

[32] Treas. Reg. 1.643(a)-3(e), Example 7.

[33] Presumably, the trust would continue to pay the taxes on income earned by the assets legally owned at that point by the beneficiary, possibly at higher marginal rates than would apply if the income were properly reported by the beneficiary. If and when the trustee and beneficiary discover the misreporting, filing amended returns and claims for refund should be considered, as should the effect of statutes of limitations and the potential mitigation of those statutes via

b. Preemptive Planning: Identify for the Trustee the "Measuring Lives" for the RAP Savings Clause

The thoughtful planner will encourage the settlor of an irrevocable trust to provide to the trustee (or if the settlor is the trustee, associate with the trust records) a family tree or other helpful listing of the "measuring lives" living at the time of the trust instrument's execution (or suggest that the successor trustee to do so at the settlor's death with regard to the settlor's (previously) revocable trust). Consider also incorporating that information in the suggested "Important Dates" exhibit to the trust instrument discussed in section VI.B.3 of this outline. Armed with that information, a future trustee should ultimately be well-positioned to identify the surviving measuring life (or the prospective "candidates" for that designation) and upon that individual's death initiate the 21-year countdown until the trusts' termination under the trust instrument in compliance with the RAP.

VII. ERROR-PROOFING SUGGESTION #6: CREATE AN ILIT AS GRANTOR TRUST TO ACCOMMODATE A TAX-FREE FUTURE "REPAIR"

A. Anticipated Problem: ILIT's Maintenance Will be Faulty, Necessitating a Tax-Free "Repair"

Inevitably, a trust's intended purpose may be undermined by improper "maintenance" by the trustee or an advisor. This is not an uncommon occurrence with an ILIT, which is a conventional estate planning technique that has traditionally required a fair level of maintenance by the trustee and to a lesser extent its settlor. As we will learn from the Example below, it is therefore best practice to incorporate non-judicial avenues for repairing a "broken" ILIT in the trust instrument **<u>and</u>** (as previously discussed) adopt "backstop" measures designed to minimize or avoid altogether the otherwise potentially irreversible damage done to an ILIT if its maintenance is neglected.[34]

> **<u>Example</u>**: Husband is the insured with respect to a whole life policy. In 2010, Husband and Wife partitioned the policy and an equivalent amount of cash held by them as community property into separate property shares. Husband's partitioned share was funded with the policy, and Wife's share was funded with the cash. Husband subsequently contributed the policy to an ILIT benefitting Wife and their two children (the "Original ILIT").
>
> Unfortunately, Husband's attorney created Original ILIT as a complex trust by conditioning all distributions to or dispositive powers exercisable by Wife on an adverse party's consent based upon the mistaken belief that the only benefit provided by grantor trust status is the grantor's ability to pay the trust's income taxes and thus permit its assets to grow tax-free, which insured's attorney did correctly note is inherently a feature of most insurance policies. Ideally, Husband's attorney would have considered that due to the almost inevitable maintenance issues that arise with ILITs, it is preferable to create an ILIT as a grantor trust to preserve the ability to pursue a tax-free corrective sale of a policy of the nature proposed below without having to engage in the initial step of converting an ILIT from a complex trust to a grantor trust prior to the sale. As discussed later in this outline, Husband will ultimately regret creating Original ILIT as a complex trust, which may have been a decision made by his attorney without consulting Husband.
>
> In each of 2010 and 2011, Husband and Wife dutifully executed a partition agreement providing for the partition of community property cash equal in value to twice the premium due (or a total of $10,000). Husband contributed his partitioned separate property funds ($5,000) to the trustee of Original ILIT in each of those years to facilitate the trustee's payment of the premium due. However, in 2012 and subsequent years Husband and Wife neglected to sign a partition agreement prior to Husband's contribution of $5,000 of community property cash to Original ILIT.
>
> Unfortunately, Husband's attorney did not incorporate a prohibition against contributions of community property in the trust instrument as a safeguard.[35] As a result, Wife contributed $2,500 in 2012 and each subsequent year (representing her community property half of the contributed funds). Because Wife is a beneficiary of Original ILIT, her gifts to Original ILIT

IRC §§ 1311 – 1314 and judicial doctrines such as equitable recoupment.

[34] See previous sections of this outline for more detailed discussions of these concerns.

[35] See section V of this outline for a more detailed discussion of this recommended practice.

result in Wife having self-settled Original ILIT in part, with the self-settled portion being continually recalculated as contributions by either spouse are made (as calculated at any point, the "Self-Settled Percentage"). Consequently, Wife's estate will include the Self-Settled Percentage of the assets held in Original ILIT at her death, whether that is the unmatured policy (if Husband survives her) or the invested death benefits (if Husband predeceased her).[36]

While the general focus of this outline is preemptive planning (and thus Section VII.B should be reviewed for a recommended means of avoiding the unfortunate result for Original ILIT summarized above), the author hopes the following summary of the steps to be taken in conjunction with the proposed corrective conversion of Original ILIT from a complex trust to a grantor trust as to both Husband and Wife (with respect to each's contributions) to accommodate its tax-free sale of the policy to New ILIT will be helpful guidance to both the planner who unfortunately finds himself or herself in need of this "repair" and to the drafter who may need a little convincing that a seemingly unnecessary grantor trust status may later prove invaluable.

Before we delve into those corrective steps, let's review a few key concepts.

1. <u>Overview of Relevant Tax Concepts</u>

a. Transfer-for-Value Rule[37]

Life insurance proceeds are generally not taxable for income tax purposes. However, if a policy was sold during the insured's lifetime, then the proceeds in excess of the transferee's investment in the contact (i.e., the acquisition consideration and post-acquisition premiums paid) will be taxable income to the beneficiary at the insured's death.[38]

There are a number of exceptions to that general rule, including a transfer of the policy to the insured or a transfer by which the transferee takes an income tax basis in the policy determined entirely or partially by reference to the transferor's basis in the policy (the "tacked-basis exception").[39]

In keeping with the reasoning of Rev. Rul. 85-13, a sale of a policy between trusts that are grantor trusts as to the insured will be ignored for income tax purposes (and thus will not result in taxable income) because the grantor will be deemed on both sides of the sale. Similarly, a grantor trust's purchase of the policy from a third party would be deemed a sale by the third party to the insured (again, an exception to the transfer-for-value rule).[40]

Once a policy has been transferred for value in a transaction that failed to quality for one of the exceptions, there is no avenue for removing the "contamination" of the policy other than via its transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.[41]

b. Taxation of a Policy's Sale

While the transfer-for-value rule regards the income taxation of policy proceeds at the insured's death, a sale of an insurance policy can also result in ordinary income and/or capital gain at the time of sale, depending upon the type of policy sold, the identities of the seller and purchaser, the amount realized via the sale, and the policy's adjusted basis (i.e., premiums paid plus any acquisition consideration if the policy was purchased from a prior policy owner). Generally, the proceeds in excess of the seller's adjusted basis in the policy will be taxed as follows: (i) as ordinary income to the extent the policy's cash surrender value exceeds its adjusted basis (i.e., an application of the "substitute for ordinary income" doctrine) and (ii) as capital gain to extent the sales proceeds exceeds the cash surrender value. [42]

c. Grantor Trust Rules

Generally, a grantor trust has a legal existence separate and apart from its grantor for gift and estate tax purposes but not income tax purposes. Thus, its assets

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[36] The estate inclusion would occur pursuant to IRC § 2036 due to Wife's distribution rights under the trust instrument and possibly IRC §2038 as well, if she is given an inter vivos and/or testamentary power of appointment.

[37] IRC § 101(a)(2). For a detailed discussion of the transfer-for-value rule, see Donald O. Jansen, Esq. and Lawrence Brody, Esq., <u>The Often Overlooked Income Tax Rules of Life Insurance Policies</u>, Willamette Management Associates' Insights (Autumn 2013).

[38] IRC § 101(a)(2).

[39] IRC § 101(a)(2)(A) and IRC § 101(a)(2)(B), respectively.

[40] As discussed below, Rev. Rul. 85-13, 1985-1 CB 184 (concluding that a sale between a grantor trust and its grantor should be ignored for income tax purposes because the grantor is deemed to be on both sides of the transaction). Priv. Ltr. Rul. 201332001 (Aug. 9, 2013)

[41] Treas. Reg. § 1.101-1(b)(3)(ii), 1.101-1(b)(5), examples 5, 7. Barring such a transfer, the policy owner will have taxable income equal to the death proceeds in excess of the owner's investment in the contract, which will include all consideration paid by all prior owners.

[42] See Rev. Rul. 2009-13, 2009-21 IRB 1029, which addresses the tax consequences of a policy sold via a life settlement arrangement but should also be applicable in "friendly" sale. Note, Congress legislatively overruled Rev. Rul. 2009-2013 in part via IRC § 1016(a)(1)(B), which rejected the Service's prior position that the calculation of a policy's adjusted basis required a reduction to premiums paid for "cost-of-insurance" charges.

will not be includible in the grantor’s estate at death. However, the grantor will be deemed the owner of a grantor trust’s assets for income tax purposes.

As a result, any transactions the grantor has with a grantor trust or any transactions that one grantor trust enters into with another grantor trust (i.e., the proposed policy sale discussed below) will be ignored for income tax purposes because based upon the reasoning set out in Rev. Rul. 85-13 the grantor will be deemed to be on both sides of the transaction. Consequently, if both Trust 1 and Trust 2 are grantor trusts with respect to the same individual at the time of the sale of an asset from Trust 1 to Trust 2, no capital gains tax will be due in conjunction with that sale and none of the interest Trust 2 pays to Trust 1 on any note it may provide Trust 1 in conjunction with its purchase of the asset will be taxable interest to Trust 1 or to its grantor (as would otherwise have been the case had a third party been the purchaser and payor for the note).

2. Possible “Repairs?”

What can be done to avoid an inclusion in Wife’s estate of the Self-Settled Percentage of the policy or the proceeds payable with respect to it?

a. Post-Contribution Partition – Not a Viable Repair

Husband and Wife cannot partition the contributed community property funds once they are held in the ILIT because the funds belong at that point to the ILIT, not them.

b. Distribution of Contributed Community Funds to Wife – Not a Viable Repair

Conventional wisdom suggests that the Trustee cannot distribute to Wife her share of the contributed community property funds due to the proverbial “cream in the coffee” issue. Based upon those same concerns, Wife may be unable to avoid an estate inclusion of trust property via a relinquishment of her beneficial interests (and appointment discretion, if any) in the portion of the ILIT attributable to her contributions (or via a trustee modification designed to achieve that same result), assuming that would even be a palatable solution to her.

c. Husband’s Purchase of Policy from Original ILIT Using Separate Property Funds and Contribution/Sale to New ILIT – Arguably Not a Viable Repair

Husband could purchase the policy from Original ILIT for its fair market value with his separate property funds without running afoul of the transfer-for-value rule (via the transfer to the insured exception) but capital gain and/or ordinary income would be recognized if the policy’s current value exceeds its adjusted basis.[43]

Husband would then need to reset with a contribution of the policy to a new ILIT intentionally created as a grantor trust with respect to him, which would result in additional use of gift tax exemption based upon the policy’s existing value and would restart the 3-year survival period under IRC § 2035 (unless Husband were to sell the policy to that new ILIT on an installment basis, which would require a “seeding” in an amount equal to 10% of the policy’s existing value and an adherence to other best practices for such a sale).

d. Sale of the Policy By Original ILIT to New ILIT – the Suggested Repair

Given all of the negatives associated with the previously proposed options, the conventional “repair” for this sort of situation is a sale of the policy by the trustee of Original ILIT to the trustee of a new ILIT (the “New ILIT”) created solely as a grantor trust with respect to Husband. Let’s examine how that sale best achieves Husband’s objectives.

(1) Overview

New ILIT would be created as a grantor trust and funded with sufficient cash to provide it with the conventionally considered necessary 10% “seed” gift to support its purchase of the policy in return for a note given to the trustee of Original ILIT with (i) a principal amount equal to the policy’s fair market value as of the sale date and (ii) interest calculated at a market-based rate.[44]

New ILIT could be identical in terms to Original ILIT (as is assumed for ease of discussion), if the only basis for its creation is to minimize the value ultimately includible in Wife’s estate (as discussed in more detail below). However, New ILIT could have terms different than those of Original ILIT.

[43] See Section VII.A.1.b of the outline for a discussion of these issues.

[44] Arguably, the trustee of Original ILIT should negotiate a market-based interest rate, rather than consent to interest being calculated at the AFR corresponding to the selected note term. It generally makes sense to use the AFR in conjunction with a sale to a grantor trust by its grantor, who is not a fiduciary and is likely happy to give the trustee a “deal” in the form of a below-market interest rate that is nevertheless considered sufficient enough pursuant to IRC § 7872 to avoid the settlor being deemed to have made a gift in consenting to that (relatively) low rate. However, given the fiduciary duties a trustee owe to the beneficiaries, it is a very different situation for the trustee to consent to interest on a promissory note paid to it being based upon the AFR applicable for the note’s term. While Original ILIT’s trustee may be receptive to an interest rate equal to the AFR if both ILITs have the same beneficiaries, the author feels a negotiated market-based rate is important to the “optics” of the sale and positioning it to withstand challenge.

Of course, the Original ILIT trustee cannot simply indulge Husband's wish to pursue the policy's sale to New ILIT. The Original ILIT's trustee should do his or her due diligence in considering the proposed sale and be particularly cautious if the New ILIT eliminates beneficiaries or alters beneficial interests.[45]

Of course, Husband could "encourage" Original ILIT's trustee to consider such a sale by informing the trustee that he will not be providing the trustee with any additional funds that would otherwise be used by the trustee to facilitate future premium payments. If so, Original ILIT's trustee is put in the position of having to explore all available options going forward. While a sale of the policy to an unrelated third party (i.e., a life settlement) or a conversion of a whole life policy to a paid-up policy may be viable options, the trustee may ultimately determine that a sale of the policy to New ILIT may be the most ideal option.

(2) Benefit of the Sale

The proposed sale effectively serves as an "estate freeze" for Original ILIT (and thus the portion of its assets includible in Wife's gross estate) because New ILIT's trustee as the policy's owner will receive all of the death benefits, while the trustee of Original ILIT will only receive payments due on the note. This inter-ILIT sale is analogous in that respect to a sale by a grantor of an appreciating asset to an irrevocable grantor trust in return for a promissory note, which is eventually paid by the trust using in part the acquired assets' post-sale income and appreciation.

Ultimately, only the Self-Settled Percentage of the property held in the Original ILIT at Wife's death (and not that percentage of the insurance proceeds) will be includible in Wife's estate. That property will either be the promissory note and investments acquired via interest payments on the note (if Husband survives Wife and the note remains outstanding) or investments acquired by the Original ILIT with funds received from New ILIT in payment of the note using the insurance proceeds New ILIT received at Husband's death (if Husband predeceases Wife). The balance of the insurance proceeds would remain in New ILIT and be excluded from Wife's gross estate.

(3) Trustee Due Diligence

While a detailed discussion of best practices for an insurance policy's sale is beyond the scope of this outline, it is crucial that the trustees of Original ILIT and New ILIT (which should not, at least at the time of sale, be the same person due to the conflicting fiduciary agendas) be mindful of their respective fiduciary duties and consequently be thoughtful in negotiating the terms of that sale. The trustee of Original ILIT should also thoughtfully determine whether a sale of the policy is even prudently pursued.[46]

<u>Query</u>, should the drafter build in a few protections for the trustee of an ILIT to provide assurance that he or she may pursue a sale of the policy if the situation in our Example occurs? For example, it is good practice in an insurance trust to authorize the trustee to hold the policy as the trust's sole asset and specifically absolve the trustee (to the extent possible under state law) from any liability that might otherwise attach from failing to diversify the trust's holdings. Should the trustee also be specifically authorized to engage in a sale of the policy that results in the trust holding only a promissory note for an extended period of time? Should the trustee be given specific authority to rely upon a policy valuation provided by the insurance company based upon the policy's interpolated terminal reserve so that the trustee will not be obligated to secure a third party appraisal of the policy prior to a sale of the nature discussed, particularly if the trust lacks sufficient funds to obtain an appraisal? These are all questions the drafter of an ILIT will want to consider.

(4) Facilitating the Sale on a Tax-Free Basis

Can the proposed sale occur on a tax-free basis? The short answer is "yes," if New ILIT is created as a grantor trust and if Original ILIT can be converted to a grantor trust as to Husband and Wife (with regard to each's contributions) prior to the sale.[47]

Because Husband will be treated for income tax purposes as the owner of New ILIT, he will be deemed the purchaser of the policy, excepting the sale from the transfer-for-value rule. <u>**If**</u> Original ILIT is a grantor trust as to Husband and Wife with regard to each's contributions at the time of the sale, New ILIT's

[45] For purposes of this discussion, it is assumed that the Original ILIT's trustee is safely within his or her fiduciary discretion in pursuing the proposed sale of the policy to New ILIT.

[46] For a discussion of best practices when coordinating a sale of an insurance policy from a "broken" ILIT to a new ILIT, see Sebastian V. Grassi, Jr., <u>Drafting a Flexible Irrevocable Life Insurance Trust,</u> 31 ACTEC J. 208 (Winter 2005). See also Kristin L. Brown, "Roses are Red, My ILIT Makes Me Blue: Replanting an Insurance Policy," State Bar of Texas 30th Annual Estate Planning & Probate Drafting Course, Houston, Texas, October 24, 2019.

[47] If Original ILIT were a grantor trust with respect to income or principal but not both, any apportioning of the sales proceeds between fiduciary income and principal under state law or the ILIT instrument would need to be considered in evaluating the income tax consequences of the policy's sale. Note, consideration of the fiduciary and public policy implications of a trustee/other fiduciary or a beneficiary (via an "administrative" power of appointment, as described in section VII.C) being able to impose grantor trust status on an unreceptive settlor exceed the scope of this outline.

purchase of the policy from Original ILIT can also occur without causing the latter to recognize ordinary income or gain (i.e., if the policy has a fair market value that exceeds its adjusted basis) as discussed in subsection (5) below, which also explores the mechanics involved with the accommodating conversion of Original ILIT to a grantor trust as to Husband and Wife with regard to each's contributions.

(5) Mechanics of Original ILIT's Conversion to Grantor Trust

As previously noted, Husband's attorney misguidedly created Original ILIT as a complex trust. Consequently, Original ILIT's trustee will need to convert it to a grantor trust with respect to each of Husband and Wife to the extent of his or her contributions in order to pursue the proposed sale of its policy to New ILIT on a tax-free basis.

(A) Evaluating Means of Conversion to Grantor Trust

We are then left to consider how to convert Original ILIT from a complex trust to a grantor trust with respect to each of Husband and Wife to the extent of his or her contributions. Assume the trust instrument does not allow for an easy conversion of Original ILIT to a grantor trust via (for example) a strategic trustee appointment or via a provision to each spouse of a "swap power" described in IRC § 675(4)(C) by an independent trustee or other fiduciary with modification discretion under the trust instrument.

While Original ILIT's trustee could request a judicial modification of it to add a "swap power," judicial proceedings can be relatively time consuming, expensive, public, and result in an unwelcome outcome. Instead, the trustee of Original ILIT may be able to convert it to a grantor trust via a merger of Original ILIT with (or a decanting of its assets to) a newly created grantor trust ILIT designed to be the "survivor" of the merger or decanting.[48]

While any one of these options may be a successful avenue for achieving grantor trust status for the Original ILIT, they each have their attendant burdens and risks for the trustee of Original ILIT. The trustee will need to determine what disclosures are owed to the trust beneficiaries (and potentially the state attorney general, if there is a charitable element to the trust) and consider other fiduciary duties implicated in pursuing a conversion to a grantor trust.

But are we getting ahead of ourselves? How can the sale of the policy in our situation still be tax-free given that Original ILIT will be converted to a grantor trust as to <u>each of</u> Husband and Wife but New ILIT will be a grantor trust as to only Husband? The answer is because the sale will in part be (i) partially ignored for income tax purposes because Husband cannot in his capacity as the deemed owner of his grantor trust portion of Original ILIT sell an asset to himself in his capacity as the deemed owner of New ILIT (again, created entirely as a grantor trust with respect to him), and (ii) partially treated pursuant to IRC § 1041 for income tax purposes as a gift (rather than a sale) from Wife in her capacity as the deemed owner of her grantor trust portion of Original ILIT to Husband in his capacity as the deemed owner of New ILIT. As a caveat, part of the interest paid on the note provided by New ILIT to Original ILIT will be taxable income to Wife to the extent deemed paid to her grantor trust portion of Original ILIT because interest on a note issued by one spouse to another creates taxable income to the recipient spouse.[49]

(B) Assigning Costs of Conversion

Keep in mind that a new trust instrument will be required to facilitate the trust merger or may be appropriate to facilitate the decanting (as applicable) necessary to accommodate Original ILIT's conversion to a grantor trust (or a trust amendment will be necessary if a modification by an independent fiduciary under the Original ILIT instrument is the pursued "repair").[50] Additionally, the trustee of Original ILIT will be required to spend time and effort confirming the tax-free nature of the conversion to grantor trust status and evaluating conversion methods. Depending upon the trustee's comfort level, he or she may wish to (and arguably should) obtain a private letter ruling confirming the tax-free nature of the conversion and possibly obtain an opinion letter from a credential attorney concluding that the trustee will not be in violation of any fiduciary duties in pursuing the desired relief, which may be seen by the beneficiaries as an expensive source of comfort to the trustee and thus arguably should be expressly noted in the trust

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[48] See Melissa J. Willms, <u>Decanting Trusts: Irrevocable, Not Unchangeable</u>, Corpus Christi Estate Planning Council, March 26, 2015 for a detailed discussion of the many issues to consider in converting a complex trust to a grantor trust, including the possibility of an income tax-free conversion.

[49] See section V.B of this outline for a more detailed discussion of this issue.

[50] See section XI of this outline for a discussion of the appointment of a fiduciary given the discretion to make modifications to the trust instrument. Query, can the "new" Original ILIT created to merge with the "old" Original ILIT be nominally funded or is a meaningful funding of the "new" Original ILIT necessary? Some planners have expressed concern with this aspect of a trust merger used as the suggested repair, which may make a decanting the preferable corrective technique. Note that Texas Trust Code Section 112.0715 now permits for a trust decanting to a new trust created pursuant to the same trust instrument as the initial trust.

instrument as an option available to the trustee in that circumstance.[51]

Who should pay the costs associated with Original ILIT's conversion to a grantor trust and the costs of the subsequent sale by it to New ILIT? Typically, the grantor(s) will absorb these types of costs, which is certainly appropriate (although not legally required) if the need for the sale is driven (as in our example) by Husband and Wife's failure to partition community property funds before contributing those funds to Original ILIT. Of course, a grantor's payment of those expenses are likely to be considered for tax purposes as an indirect gift to each ILIT to the extent of the expenses paid on its behalf.

But what if Husband and Wife refuse to pay those expenses? Would the trustee of Original ILIT have a responsibility to pursue the "repairs" to avoid part of the trust assets being subject to Wife's creditors and ultimately inclusion in Wife's estate (possibly resulting in estate taxes pursuant to IRC § 2207B being borne by Original ILIT)? If the policy is likely to have sufficient cash value that the trustee can access for this purpose (via a withdrawal or loan) or if Original ILIT is anticipated to hold other assets, the forwarding thinking drafter may (with the grantor's blessing, of course) want to consider suggesting in the trust instrument that the trustee "consider" pursuing a "repair" along these lines if the economics make sense. However, if the policy is a term policy and Original ILIT has no other assets, then the trustee should be relieved from doing so in the trust instrument.

What if the trustee is the party responsible for Original ILIT's "faulty" maintenance? Would he or she be personally liable for the "repair" expenses? An in depth discussion of these fascinating issues is beyond the scope of this presentation. However, the "Ultimate Worrier" would be well-advised to consider them and address them as appropriate in the trust instrument.

B. Preemptive Planning: Create an ILIT as a Grantor Trust or Draft the Trust Instrument to Accommodate an Easy Creation of Grantor Trust Status

Many of the previously noted concerns could have been avoided had the attorney coordinating Original ILIT's creation been a little more thoughtful and forward thinking by creating it as a grantor trust or at the very least providing an independent advisor appointed in the trust instrument with the discretion to activate a "swap power." While there may not be any immediate benefits to creating an ILIT as a grantor trust, there is also generally no downside to doing so, which may ultimately prove critical in pursuing tax-free "repairs" to the ILIT if its maintenance proves less than perfect.

C. Alternative Preemptive Planning: Give the Current Beneficiary an "Administrative" Inter Vivos Special Power of Appointment

As previously noted, there are many factors for a trustee to consider in evaluating the options available as a "repair" for an ILIT whose maintenance has been faulty, many of which have some concerning implications from a fiduciary duty perspective. Given that, should planners instead consider pursuing a conversion of a complex trust to a grantor trust and other "repairs" to irrevocable trusts administrative in nature via a beneficiary's exercise of an inter vivos "administrative" special power of appointment?

As previously discussed, the prudent trustee or other advisor pursuing a merger, decanting, or other relief would necessarily be required to consider the fiduciary duty implications of doing so and the potential for a beneficiary challenge. In contrast, a beneficiary does not act as a fiduciary when exercising a conventional power of appointment. However, would a beneficiary exercising an inter vivos "administrative" power of appointment to achieve the same desired administrative updates actually be considered a fiduciary pursuant to Texas Trust Code Section 114.0031 and therefore constrained by the same types of concerns?[52] As a practical matter, the beneficiary may have carte blanche in that regard, particularly if he or she has the ability to "relieve" an otherwise contesting remainder beneficiary of his or her beneficiary status via a testamentary special power of appointment exercise. After all, as Professor Stanley M. Johanson has observed, a power of appointment is also a "power of disappointment."

Can a beneficiary appoint assets from an existing trust to a newly-created trust benefitting him or her with

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[51] Note, the IRS will not currently issue private letter rulings regarding the tax consequences of a trust decanting. See Rev. Proc. 2020-3, 2020-1 I.R.B. 131.

[52] See Texas Trust Code Section 114.0031(e), which provides that a person authorized to "direct, consent to, or disapprove a trustee's actual or proposed investment decisions, distribution decisions, or other decisions" is considered an "advisor" and a fiduciary when exercising that authority. The statute further provides, however, that an advisor may act in a nonfiduciary capacity if his or her sole power is directing the removal and appointment of fiduciaries (excluding himself or herself). The statute further provides that a trustee acting at the direction of an "advisor" can only be held liable in cases of willful misconduct.

Query, is the delegation of discretions traditionally held by a trustee to the advisor (and the resulting "lowering of the bar" for the trustee's standard for liability) the basis for the advisor's fiduciary status pursuant to Texas Trust Code Section 114.0031(e)? If the beneficiary is not usurping the trustee's general discretion via an exercise of the "administrative" power of appointment, then perhaps it is arguable that the beneficiary should be considered to be acting in a nonfiduciary capacity, as has been traditionally the case?

the desired updated administrative terms without causing the appointed assets to be includible in his or her estate pursuant to IRC § 2041 as long as his or her beneficial interests remain unaltered? We know that if a beneficiary cannot exercise a power of appointment "in favor of" himself or herself, his or her estate, or creditors of the beneficiary or the beneficiary's estate, then the power is not considered a "general power of appointment" pursuant to IRC § 2041. If the beneficiary can only exercise the inter vivos "administrative" power of appointment to direct the distribution of trust assets to another trust for which he or she has the same beneficial interests, then it seems that power is arguably not a general power of appointment pursuant to IRC § 2041. Rather, it reasons that in order for a power to be exercisable "in favor of" the holder and thus a general power of appointment, he or she must be able to exercise the power to expand his or her beneficial interests.[53] As a caveat, the author has found no definitive authority confirming that belief.

VIII. ERROR-PROOFING SUGGESTION #7: DO NOT SET THE TRUSTEE UP FOR FAILURE

A. Anticipated Problem: Trustee Will Overlook Administrative Tasks Unnecessarily Imposed by Trust Instrument

A trustee's job can be a thankless one. Accordingly, the planner should be mindful to avoid unduly complicating the trustee's administration of a trust and possibly setting the trustee up for failure by saddling the trustee with arguably unnecessary responsibilities, as long as doing so will not frustrate the settlor's objectives for the trust or otherwise impair the beneficiaries' intended interests.

B. Preemptive Planning: Do Not Set the Trustee Up for Failure

1. Limit in Trust Instrument Required Accountings and Other Disclosures

A trustee of an irrevocable trust is not obligated to provide accountings to the beneficiaries unless requested by a beneficiary in writing or directed by a court, although the trustee can be authorized in the trust instrument to refuse a remainder beneficiary's request for an accounting.[54] A trustee also has a non-waivable common law duty to provide ongoing disclosures regarding the trust's administration to current beneficiaries over the age of 25 but may forgo those disclosures to all other beneficiaries, if the trust instrument permits.[55] Accordingly, consider providing in an irrevocable trust instrument that the trustee is only required to provide current beneficiaries over the age of 25 with such information regarding the trust's administration as is necessary to comply with the common law duty of disclosure and confirm those disclosures need not take the form of accountings unless requested by a current beneficiary.[56]

As a caveat, this is generally recommended drafting for the trust instrument based upon the objective of simplifying the trustee's duties, provided the settlor is comfortable entrusting the trustee with this level of autonomy and the trustee understands that fiduciary duties are still owed to all beneficiaries. While the prudent trustee in that event may opt (and generally should be counseled) to provide disclosures beyond those required under the trust instrument, the trustee will not be obligated to do so and therefore will not be automatically in breach of his or her fiduciary duty if he or she neglects to provide those additional disclosures.[57]

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[53] While a beneficiary's exercise of an "administrative" special power of appointment to convert a complex trust to a grantor trust would ultimately cause the trust to hold greater value via the retention of funds that would have otherwise been used to pay taxes, there would be no guarantee that the beneficiary would benefit from those retained funds via distributions under the applicable distribution standard. Given that, it seems plausible that the beneficiary could hold that discretion without being deemed to hold a general power of appointment, particularly if the trust instrument directed that any tax savings accruing to the trust in that event would not be distributable to the beneficiary. Of course, the "Ultimate Worrier" may want to seek a private letter ruling confirming that belief.

[54] Texas Trust Code Sections 111.0035(b)(4) and 113.151.

[55] Texas Trust Code Sections 111.0035(c). There is a great deal of uncertainty regarding the extent of the disclosures required pursuant to that duty. For a more detailed discussion, see David F. Johnson, A Trustee's Duty to Disclose in Texas, Tarrant County Bar Association Business and Estate Section, Fort Worth, Texas, October 20, 2016.

[56] It may be advisable to consider providing that these more limited trustee disclosure requirements only apply to individual trustees, unless the settlor specifically wishes to prevent overall disclosures from being provided to the greatest extent permissible. Typically, corporate trustees prefer to provide disclosures to current and remainder beneficiaries with the goal (in part) of initiating the statute of limitations period during which a beneficiary can challenge a trustee's trust administration, although even corporate trustees prefer to provide those disclosures via transaction statements that do not typically adopt the formatting of a statutory accounting.

[57] Note, more detailed and more widely circulated disclosures may enable the trustee to build a better rapport with beneficiaries, as well as cause the statute of limitations period associated with a breach of fiduciary duty claim to begin to run at an earlier time than would otherwise be the case. The trustee who is concerned with a beneficiary challenge would be well-advised to keep this in mind.

2. <u>Simplify Documentation Requirements and Transmissions</u>

Avoid overcomplicating documentation requirements. Trustee resignation and acceptance documents are not typically filed in the deed records and thus do not need to be notarized. Consider eliminating the requirement that either (and other documents of similar nature) be notarized.

Traditionally, trust instruments have required that trustee resignations and other notices be provided via a signed document either personally delivered or sent by certified mail. As with the notarization requirement, these methods of delivery are often required more out of habit than usefulness. A trustee can obtain a similar assurance of a document's receipt by sending it via electronic mail subject to an automated confirmation of delivery or opening (or by requiring an actual confirmation of delivery via the intended recipient's response to the email), as permitted under the trust instrument. Of course, the trustee will want to save those communications for later provision to the IRS, if requested.

3. <u>Permit the Waiver of "Waiting Periods"</u>

Frequently, a trust instrument will provide that the settlor and/or beneficiaries be given notice of certain changes in a trust's administration and delay the effectiveness of those changes for a designated notice period (e.g., 30 days). Examples of such an event include a trustee's resignation, a trustee's waiver of compensation, or a trust merger. While it may be generally appropriate to provide a settlor or beneficiary with notice of such an event and a period during which to adjust to the change in the trust's administration, the settlor or beneficiary may not require the entire notice period for that purpose. Accordingly, it is generally a good idea to permit the settlor or beneficiary to waive the full notice period so that the effectiveness of the intended change in the trust's administration may be accelerated.

IX. ERROR-PROOFING SUGGESTION #8: DIVORCE-PROOF THE PLAN

A. Anticipated Problem: Client and Client's Divorce Counsel Will Not Consider Impact of Divorce Upon Estate Plan

As planners, we spend a significant amount of time working with our clients to craft an estate plan that will accomplish all of their objectives. For our married clients, those objectives typically include providing for the estate of the first spouse to die (the "Deceased Spouse") to pass to the survivor (the "Surviving Spouse") to supplement his or her own resources and thereby ensure he or she will have the financial means to maintain his or her accustomed lifestyle, while also deferring any estate taxes otherwise due at the Deceased Spouse's death until the Surviving Spouse's death. The Deceased Spouse will often opt to pass his or her estate to the Surviving Spouse in trust to ensure that any assets remaining at the Surviving Spouse's death will ultimately pass to descendants, often in further trust. Spouses will also often want each other and one or more other family members (e.g., a sibling or parent) to serve in some capacity in administering the plan after death (or earlier incapacity), whether as trustee of trusts for the Surviving Spouse and ultimately descendants or possibly as guardian of any minor children.

Of course, an individual's desire to provide for his or her spouse's well-being and entrust the management and distribution of his or her estate to that spouse's care and possibly the care of that spouse's family members may lessen in the event of divorce. While it is always recommended that each spouse update his or her estate plan once the decision to divorce has been made (or possibly even before that step has been taken) to ensure it reflects his or her newly held objectives, neither spouses nor their divorce counsel are typically inclined to be prospective in their thinking in that regard when they are wading through the divorce process.[58]

B. Preemptive Planning: Divorce-Proof a Client's Estate Plan

State law will generally remove spouses as beneficiaries and fiduciaries of each other's estate plan upon finalization of their divorce and for some purposes will similarly remove an ex-spouse's family members (other than joint descendants) as beneficiaries and fiduciaries under the plan.[59] However, given the risk of

[58] Note, Section 253.001 of the Texas Estates Code prevents a judge from issuing a standing order prohibiting divorcing spouses from updating their wills, although the judge can issue a temporary order prohibiting a spouse from revising a beneficiary designation for an insurance policy on either spouse's or a child's life pursuant to Section 6.501 of the Texas Family Code. If a client is mindful of the need to update his or her documents while a divorce is pending, it will generally be important to provide copies of the updated powers of attorney and related documents and beneficiary designation forms to third parties in possession of the outdated documents, as well as provide copies of the updated powers of attorney to the soon-to-be ex-spouse in order to confirm with him or her that his or her appointment as agent under those documents has been revoked.

[59] See Texas Family Code Section 9.301 (regarding life insurance, limiting elimination as a beneficiary to an ex-spouse) and Texas Family Code Section 9.302 (regarding

incapacity or an untimely death, it often does not make sense for a spouse to rely upon state law to remove the soon-to-be ex-spouse and his or her relatives (if applicable) from the plan upon the finalization of the spouses' divorce, which may take years depending upon the complexity of the assets to be divided and any child custodial issues to be addressed.[60] Consider instead whether it makes sense to trigger the removal of the soon-to-be ex-spouse and his or her relatives from the other spouse's estate plan at an earlier time under the governing instrument, whether (for example) upon the filing of a petition by either spouse or by either spouse's decision to move out of the residence as a result of marital difficulties.[61] If so, consider the use of text similar to the following in the spouses' joint revocable management trust (or in an appropriately modified format for a spouse's separate revocable trust or conventional will):

> "A. Effect of Settlors' Divorce. In the event the Settlors are not married to each other at the death of the Deceased Settlor, then each of the Surviving Settlor, his or her parents, and any descendants of the Surviving Settlor's parents who are not also descendants of the Deceased Settlor shall be treated as if he or she had died on the date of the Settlors' divorce for all purposes of this Trust Agreement (including fiduciary appointments), except as pertains to the Surviving Settlor's separate property and share of the community property then held in trust hereunder. For purposes of this Subsection, the Settlors shall be deemed divorced at the time of the Deceased Settlor's death if either or both of the following then apply: (i) either Settlor previously filed a petition for divorce that then remained outstanding; or (ii) the Settlors are then living apart, provided that if the Settlors are then living apart by reason of one or both of them being ill, residing in an assisted living facility, on vacation, traveling for business reasons or other similar causes and they had been living together at the time such separation commenced, then the Settlors shall be deemed to have been living together at the Deceased Settlor's death."[62]

IRAs, limiting elimination as a beneficiary to an ex-spouse); Texas Estates Code Section 123.001 (regarding wills, addressing elimination of both the ex-spouse and his or her relatives as beneficiaries and fiduciaries under the will itself and under any irrevocable trust in receipt of assets via the will to the extent of those assets); Texas Estates Code Sections 123.052 and 123.056 (the former regarding a sole settlor revocable trust created by one spouse and the latter regarding a joint revocable trust created by both spouses, each addressing the elimination of both the ex-spouse and his or her relatives as beneficiaries and fiduciaries from the other spouse's revocable trust, whether created by him or her as the sole settlor or created by the trustee after his or her death via a division of a joint revocable trust); Texas Estates Code Section 123.151 (regarding multi party accounts, addressing elimination of both the ex-spouse and his or her relatives as beneficiaries); Texas Estates Code Section 751.132 (regarding durable powers of attorney, limiting disqualification as an agent to an ex-spouse); Texas Estates Code Section 1104.211 (regarding designation of guardian for self, limiting disqualification as a guardian to an ex-spouse); and Texas Health and Safety Code Section 166.155 (regarding medical powers of attorney, limiting disqualification as an agent to an ex-spouse). Note, while ex-spouses and their family members are removed via the Texas Estates Code from the revocable trust upon divorce as fiduciaries, any prior exercise of any discretion given them to appoint their own successor fiduciaries under the trust instrument may still need to be addressed with an update to the trust document unless it voids the exercises of that discretion in light of their removal as fiduciaries, given that the Estates Code does not directly address that scenario. Note, ex-spouses will generally need to update their beneficiary designations on file with the administrator for assets subject to the Employee Retirement Income Security Act of 1974 (or "ERISA") due to its preemption of state law. See Eglhoff v. Eglhoff, 532 U.S. 141, 144 (2001).

[60] In this instance, the word "plan" is used as a shortcut reference to a will or revocable trust, as well as to any retirement accounts, insurance policies, multiparty accounts, and powers of attorney and related documents.

[61] As a caveat, note that Section 166.164 of the Texas Health and Safety Code directs that the medical power of attorney "must be in substantially" the form contained in that statute, which provides for the removal of an ex-spouse if the marriage is dissolved, annulled, or declared void (unless the medical power of attorney provides otherwise) and may not allow for the customization necessary to trigger that removal at an earlier time. In contrast, Section 752.003 of the Texas Estates Code provides that the statutory durable power of attorney form provided in Section 752.051 of the Texas Estates Code (which provides for the removal of an ex-spouse in those same events) is "not exclusive, and other forms of power of attorney may be used." Of course, a third party proposing to enter into a transaction with the principal's spouse as his or her agent under a durable power of attorney that removes the spouse as agent upon the filing of a petition for divorce may understandably require the spouse to provide a certification pursuant to Section 751.203 of the Texas Estates Code confirming that neither spouse has filed a petition for divorce that remains on file.

[62] It may also make sense to provide in the trust instrument for the removal in the event of divorce of any charity included under the "disaster clause" (addressing the distribution of the assets remaining in trust upon the death of the survivor of the spouses and their descendants) or otherwise from a spouse's then modified estate plan, if that charity is favored primarily by the other spouse. For example, spouses may provide via the "disaster clause" for the remaining property to pass in equal shares to their alma maters. In the event of the spouses'

Unfortunately, there is no section of the Texas Estates Code or Texas Trust Code that provides in the event of a divorce for a spouse's removal as a beneficiary or trustee of an irrevocable trust created by the other spouse (or removal of the beneficiary-spouse's family members or favored charities) except with respect to assets otherwise directed to an irrevocable trust via a "pourover" will.[63] Consequently, it probably makes sense to adapt the prior text for inclusion in an irrevocable trust as well, given that divorcing spouses and their attorneys are particularly unlikely to focus on the need to address relinquishments of spousal beneficial interests and fiduciary appointments in an agreement incident to divorce or other settlement agreement.[64]

For the same reasons, it is often also advisable to include a provision similarly providing for the removal of a descendant's spouse as a beneficiary (including if he or she was added as a beneficiary via a descendant's exercise of a power of appointment) and fiduciary of a descendant's trust in the event they divorce (or more appropriately, are deemed to have divorced due to the filing of a petition for divorce by either or as a result of either spouse moving out of the residence).

Because it is increasingly common for planners to provide for such a triggered automatic removal of a soon-to-be ex-spouse in estate planning documents, the family law attorney would be well advised to review the terms of the applicable trust instrument and other estate planning documents prior to filing the petition for divorce to determine what (if any) impact the petition's filing will have on the represented spouse's interests in that regard. The filing of a petition on behalf of the represented spouse could (for example) result in the client being "deemed deceased" with regard to an irrevocable trust currently providing funds to that spouse. Similarly, spouses' behavior in anticipation of a divorce can often impact their rights and obligations under each other's estate plan (e.g., if moving out of the residence is deemed the equivalent of a divorce and removes that spouse from the other spouse's estate plan), making it important that they consult a family law attorney when an end to the marriage is anticipated to ensure that there will be no unintended consequences to any actions they take.

X. ERROR-PROOFING SUGGESTION #9: AUTHORIZE AN AGENT UNDER A DURABLE POWER OF ATTORNEY TO COMPLETE A GIFT OR ESTATE PLAN UPDATE

A. Anticipated Problem: Client May Lose Capacity Before Completion of Gift or Estate Plan in Process

Our clients lead busy lives. It may take months, if not years, for us to work with our clients in thoughtfully crafting a plan uniquely tailored to achieve their objectives and coordinating the client's execution of the implementing documents. Often times though the client is willing and able at an early stage of the engagement to at least sign their "ancillary" estate planning documents, such as financial and medical powers of attorney.

B. Preemptive Planning: Authorize the Client's Agent to Complete Gift or Estate Plan in Process

Can and should we authorize a client's agent under a durable power of attorney ("DPOA") to complete any in-process estate planning that the client may ultimately be unable to complete prior to his or her incapacity or other condition (short of death) that will otherwise prevent him or her from personally signing the necessary documents?

While to date many planners have assumed the answer to the "can" prong of that question is "yes," extensive changes to the Texas Durable Power of Attorney Act enacted in 2017 confirmed that an agent under a DPOA can complete the principal's estate plan if provided with the requisite so-called "hot powers" under the instrument.[65] Assuming the client is comfortable entrusting that discretion to the agent, the attorney must with input from the client carefully

divorce, a spouse may prefer that his or her estate pass solely to his or her alma mater. By that same reasoning, it may make sense to consider eliminating bequests to or fiduciary appointments of individuals who are primarily the friends of the ex-spouse.

[63] See Texas Estates Code Section 123.001.

[64] As a caveat, an inter vivos QTIP cannot provide for the removal of the spouse as a beneficiary in the event of divorce, consistent with IRC § 2056(b)(7) and Treas. Reg. § 20.2056(b)-7(d)(3). However, the trust instrument can provide in the event of the spouses' divorce for the Beneficiary-Spouse to be removed as a trustee and be prohibited from receiving distributions of principal other than as necessary to ensure that he or she is given a "qualifying income interest for life" (as required by IRC § 2056(b)(7)(B)(i)), which may necessitate depending upon the circumstances an allocation of principal to income (e.g., pursuant to Section 116.005 of the Texas Trust Code) or a distribution of principal made to compensate the spouse for unproductive property, consistent with Treas. Reg. § 20.2056(b)-5(f)(5).

[65] A discussion of those statutory provisions is beyond the scope of this presentation. For a detailed summary of the 2017 legislative changes to the Texas Durable Power of Attorney Act and an excellent discussion of their implications, see Lora G. Davis and Donald L. Totusek, Durable Powers of Attorney: Discussing Their Rosy Future and Answering Your Thorniest Questions, 42nd Annual Advanced Estate Planning & Probate Course, Dallas, Texas, June 14, 2018.

consider the scope of the discretion granted.[66] For example, unless otherwise provided in the DPOA, the agent's gifting authority will be limited to the gift tax annual exclusion amount (currently, $15,000) or twice the exclusion amount if the principal's spouse agrees to "gift-split" pursuant to IRC § 2513.[67]

In exercising the "hot powers," the agent generally has the duty to consider the principal's objectives in determining whether to make gifts on behalf of the principal. The agent must also exercise the hot powers in a manner that preserves the principal's estate plan, to the extent the agent has actual knowledge of the plan and preserving that plan is in the principal's best interest based upon all relevant factors, including tax minimization and other factors specifically noted in Texas Trust Code Section 751.122.

What if the principal was in the process of creating or updating his or her foundational estate planning documents or working with his or her attorney on gift planning in advance of a liquidation event at the time of his or her incapacity? If the agent wishes to exercise the hot powers to complete either planning, what level of certainty should be required that the contemplated gift is consistent with the principal's objectives or that the agent's execution of the draft foundational estate planning documents will "preserve" the principal's estate plan?

It is generally a good idea prior to drafting the necessary documents for the attorney to ensure he or she and the client are on the same page by preparing a memo or chart describing the key dispositive elements of the proposed gift or foundational estate plan and appointments of fiduciaries responsible for carrying it out. Consider having the client document his or her approval of the proposed gift/plan by signing a copy of the chart or memo and provide in the DPOA that the client's approval of the proposed gift/plan in that regard gives the agent authority to sign documents consistent with that chart or memo on the principal's behalf in the event of his or her incapacity.

XI. ERROR-PROOFING SUGGESTION #10: AUTHORIZE INDEPENDENT FIDUCIARY IN TRUST INSTRUMENT TO PURSUE NONJUDICIAL MODIFICATIONS

A. Anticipated Problem: Trust Needs Repairing to Ensure Fulfillment of Settlor's Objectives[68]

Ideally, the settlor would address every eventuality under the revocable trust instrument. As a practical matter, we know that is impossible. However, the trustee can often exercise his or her discretion to adapt a trust's administration as appropriate in light of an unanticipated occurrence, whether resulting from faulty maintenance of a trust or (for example) a change in the law. In other circumstances, the settlor will necessarily have to rely upon either a court of law or a fiduciary granted modification authority under the trust instrument to make appropriate updates and other "tweaks" to a trust's terms. For reasons previously noted, the latter is often the preferred avenue for modifications.

B. Preemptive Planning: Clarify Settlor's Objectives in Instrument and Authorize Independent Fiduciary to Modify Trust to Ensure Fulfillment

The thoughtful planner may want to consider entrusting an independent trustee or other fiduciary (a "Special Trustee") with the discretion to make modifications to the trust instrument in the event of a trust's faulty maintenance, unanticipated changes in the beneficiary's personal circumstances, changes in the law, etc. with the goal of ensuring the trust will continue to further the settlor's objectives for it despite those changes.[69]

Consider error-proofing the trust instrument against exercises of the modification discretion that could otherwise undermine the settlor's intentions. As such, summarize the settlor's objectives for the various trusts in the trust instrument (the "Material Purposes"), including the desired tax results for the various trusts (e.g., qualifying a trust for the marital deduction under IRC § 2056(b)(7) or being GST exempt). Correspondingly, expressly limit exercises of the amendment authority by the Special Trustee to those necessary to (i) clarify or reform the trust instrument to eliminate any ambiguities or other scrivener's errors that would otherwise undermine the fulfillment of those Material Purposes or (ii) ensure the continued fulfillment of the Material Purposes in light of faulty maintenance of one or more of the trusts or changes in family circumstances or the governing laws.

It is often helpful to the Special Trustee for the settlor to provide examples of circumstances in which the Special Trustee may want to consider exercising the amendment authority, recommendations for the manner in which the discretion should be exercised in those events, and illustrations of how one or more of the Material Purposes will have been accordingly fulfilled.

[66] Note, the principal may wish to grant the "hot powers" only to his or her spouse and not successor agents.

[67] Texas Estates Code Section 751.032.

[68] See section VII of this outline for a specific repair suggested for an ILIT suffering from the effects of faulty maintenance.

[69] It is typically recommended that the modification discretion be reserved solely to persons other than the settlor, beneficiaries, or anyone related or subordinate to them to avoid a loss of the creditor and/or tax protections otherwise afforded to trusts that could occur if the modification discretion were held by a related or "friendly" trustee.

It would also be a good idea to list the limitations on the Special Trustee’s amendment authority necessary to ensure that the trusts retain the desired tax, creditor, and other protections so that the amendment discretion cannot be inadvertently exercised in a contrary manner. Accordingly, it may be prudent to require that the Special Trustee consult with an attorney who is board certified in estate planning and probate or possesses a similar credential prior to exercising the amendment discretion to ensure that it will be appropriately exercised. Consider also expressly authorizing the trustee to seek a private ruling request confirming the proposed modification will not cause the trust to lose any desired tax status or other benefits.

Lastly, consider having the settlor date and sign a one or two page statement that outlines the Material Purposes for use by the Special Trustee or possibly a court in determining the settlor’s intentions. It is the rare client who reads a lengthy trust instrument in its entirety, and a court in particular may be understandably skeptical that the settlor reviewed and understood a listing of his or her “Material Purposes” buried on page sixty of the trust instrument. However, it has been the author’s experience that clients will read and contribute to a short document outlining their objectives, particularly when that document is presented in their voice without “legalese.”

XII. CONCLUSION.

Ideally, our clients and their other advisors will provide a certain level of care and attention to plans we create for our clients. As a practical matter, a client’s estate plan is likely at times to be neglected or suffer faulty maintenance. Given that possibility, attorneys and other advisors should consider preventative drafting and other complementary measures designed to shield the plan from any lasting damage in either event so that the client’s objectives will ultimately be fulfilled.