



Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A.
800 North Magnolia Avenue, Suite 1500
P.O. Box 2346 (ZIP 32802-2346)
Orlando, FL 32803

407-841-1200
407-423-1831 Fax
www.deanmead.com

Orlando
Fort Pierce
Viera

LAUREN Y. DETZEL
407-428-5114
ldetzel@deanmead.com

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Strategies for Dealing with Problem Trusts

Lauren Y. Detzel, Esq.
David J. Akins, Esq.
Brian M. Malec, Esq.

I. Introduction

A. What is the problem?

1. Unanticipated events favor withholding mandatory distributions. For example, a trust may require a distribution of 25% of the principal to a beneficiary once he or she reaches age 25; however, the beneficiary may still be in school or not mature enough to handle the money.
2. Foreseeable that a beneficiary may develop problems in the future, and current trust does not provide protections, such as spendthrift or substance abuse provisions.
3. Change in family circumstances. Births, deaths, marriages, divorces or special needs.
4. Composition of beneficiaries warrants different or competing investment strategies.
5. Desire different successor or current trustees.
6. Trustee provisions are too restrictive. To enhance administration of the trust, trustee may need more liberalized distribution or investment authority or additional powers to manage certain assets.
7. Unfavorable state law governing trust; inconvenient situs.
8. Trust contains drafting errors that create ambiguities.

9. Changes in tax law.
10. Desire to extend GST grandfathered trust.
11. Exempt GST and non-exempt GST shares are commingled creating a trust with a mixed inclusion ratio, i.e., one that is between zero and one.

B. What is the solution (i.e. what do the parties want?)

1. More or less restrictive distribution or administration provisions.
2. Remove/add a beneficiary.
3. Alter the timing of scheduled distributions.
4. Change trustees.

C. How can we get to the solution?

1. Pursuant to trust provisions providing for modification/termination.
2. Decanting.
3. Judicial and Nonjudicial Modification.
4. Sale of Assets to Grantor Trust.

II. What changes are permitted under the terms of the trust instrument itself?

1. Should always be the first place you look to. Sometimes, a Trustee or trust protector may be granted the authority to expand the class of beneficiaries of the trust, substitute current trust property with other property of equal value or make changes to comply with tax qualifications.
2. Does any person hold a limited power of appointment over trust property which may be exercised to accomplish goals?
3. Modifications expressly authorized by a trust instrument or the Florida statutes are in addition to, and not in derogation of, any modification which may be permitted under common law. For example, *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940) provides the common law authority for decanting where a trustee had a power to appoint income and principal among a class of beneficiaries. See F.S. § 736.04117(7).

III. Decanting

- A. Allows a trustee who has “absolute power” to distribute principal among one or more beneficiaries to transfer assets from one trust to a second trust for the current benefit of one or more of such beneficiaries (i.e. the beneficiaries who are the objects of the exercise of the broad distribution power).
- B. Second trust can be newly formed and contain more favorable provisions, subject to certain limitations. In essence, the trustee is substituting the new trust for the old trust.
- C. Current trust (referred to in the statute as the “first trust”) must provide trustee “absolute power” to invade principal of the trust for the benefit of one or more persons.
 - 1. Absolute power to invade principal includes power that is **not** limited to ascertainable standard (such as health, education, maintenance or support).
 - 2. Examples of absolute power include power to invade for best interests, welfare, comfort or happiness, even if the term “absolute” is not used.
- D. Trust cannot contain language expressly prohibiting decanting. A spendthrift provision or a provision which prohibits amendment or revocation is insufficient to prevent decanting.
- E. Decanting has certain statutory requirements/limitations under F.S. § 736.04117.
 - 1. Must notify all “qualified beneficiaries” at least 60 days prior to effective date of exercise, but qualified beneficiaries can waive notice period in order to accelerate effective date of exercise.
 - 2. Under F.S. § 736.0103(14), “qualified beneficiaries” are defined as living beneficiaries who:
 - a. are current distributees of income or principal (whether mandatory or permissible);
 - b. would become such beneficiaries if the interests of the current beneficiaries terminated without causing the trust to terminate; or
 - c. would be a distributee or permissible distributee if the trust terminated in accordance with its terms on that date.

** The consent of certain qualified beneficiaries may not be necessary if they are adequately represented by another consenting individual. For example, the holder of a power of appointment may represent and bind the permissible appointees and takers in default of the power, and a parent may represent and bind the parent's minor child if a guardian has not been appointed. See F.S. §§ 736.0301-0306.

3. Exercise must be in writing, signed and acknowledged by the trustee.
4. Second trust can only have beneficiaries that are included in first trust. In other words, new beneficiaries cannot be added. But, not every beneficiary of the first trust must be a beneficiary of the second trust.
5. Second trust cannot reduce any fixed income, annuity or unitrust interest in the assets of the first trust.
6. If any contribution to the first trust qualified for marital or charitable deduction, the second trust cannot contain provisions that would have reduced or prevented the deduction if included in the first trust.

F. Actions that can be accomplished with decanting:

1. Modify administrative and distribution provisions;
2. Divide trust property to create separate trusts;
3. Correct drafting errors;
4. Alter trusteeship provisions.

G. Beware of using decanting on older (i.e. pre-1986) trusts. If the trust is a "grandfathered" GST trust, meaning that it is exempt from generation-skipping transfer tax, improper exercise of the decanting power could cause the loss of exemption and subject the new trust to GST tax. See tax considerations in Article VI below.

IV. Methods of Judicial and Nonjudicial Modification

A. Judicial Modification

1. F.S. § 736.04113 - Modification not inconsistent with settlor's purpose.
 - a. Applies to all irrevocable trusts regardless of creation date.

- b. Trustee or qualified beneficiary can apply to court.
 - c. Court may modify if:
 - (i) Purposes of trust are fulfilled or have become illegal, impossible, wasteful or impracticable to fulfill;
 - (ii) Due to unforeseen circumstances, compliance would substantially impair or defeat a material purpose of the trust; or
 - (iii) A material purpose of the trust no longer exists.
 - d. Actions that may be accomplished include changing the terms of a trust, including terms governing distributions and administration, terminating the trust in whole or in part, directing or permitting the trustee to engage in unauthorized or prohibited acts, or prohibiting the trustee from engaging in certain acts permitted by the trust.
 - e. Court shall consider terms and purposes of trust, facts and circumstances surrounding trust creation, extrinsic evidence and spendthrift provisions (but presence of spendthrift provision does not preclude modification).
2. F.S. § 736.04115 - Modification in the best interests of the beneficiaries.
- a. Regardless of whether the reasons for modification provided above under F.S. § 736.04113 are present, a court may make the same modifications if compliance with the current terms are not in the best interests of the beneficiaries.
 - b. Does not apply to:
 - (i) Trusts created prior to January 1, 2001; or
 - (ii) Trusts created after December 31, 2000 if the trust contains the former rule against perpetuities period, and the trust expressly prohibits judicial modification.
 - c. Trustee or any qualified beneficiary can apply to court for modification.
 - d. Factors considered by court:

- (i) Compliance with current terms are not in best interests of beneficiaries;
 - (ii) Intent of the settlor, in light of current circumstances and interests of beneficiaries;
 - (iii) Terms and purposes of trust;
 - (iv) Facts and circumstances surrounding trust creation and extrinsic evidence; and
 - (v) Presence of a spendthrift provision is a factor, but does not absolutely preclude modification.
3. F.S. § 736.0413 - Cy Pres.
 - a. Addresses charitable trusts. Settlor, trustee or qualified beneficiary can apply to court.
 - b. Court can modify or terminate trust if particular charitable purposes have become unlawful, impracticable, impossible to achieve, or wasteful.
 - c. Modifications and distributions must be consistent with settlor's charitable purposes.
 4. F.S. § 736.0415 - Reformation to correct mistakes.
 - a. Settlor or interested person can apply to court.
 - b. Purpose is to conform trust to the settlor's intent.
 - c. Need clear and convincing evidence (> 75%) that the accomplishment of the settlor's intent and the terms of the trust were affected by a mistake of fact or law.
 - d. Possible even if the terms of the trust are unambiguous.
 5. F.S. § 736.0416 - Modification to achieve settlor's tax objectives.
 - a. Any interested person may apply, meaning any person who may reasonably be expected to be affected by the outcome of the particular proceeding involved. F.S. § 731.201(23).
 - b. Can modify terms in a manner that is not contrary to settlor's probable intent.

- c. Modification can be retroactive, but does not guarantee change will be respected retroactively.
- 6. F.S. § 736.0414(2) - Modification/termination of uneconomic trust.
 - a. Trustee or qualified beneficiary can apply to court, even if assets are greater than \$50,000.
 - b. The court can modify or terminate the trust, or remove trustee and appoint a different trustee if the court determines trust assets are insufficient to justify administration costs.
 - c. Trust can expressly prohibit termination under this section, but mere existence of a spendthrift provision does not make this section inapplicable.
 - d. Upon termination, trustee must distribute assets in a manner consistent with the purposes of the trust.

B. Nonjudicial Modification

- 1. F.S. § 736.0412 - Modification/termination pursuant to unanimous agreement of trustee and all qualified beneficiaries.
 - a. Does not apply to:
 - (i) Trusts created prior to January 1, 2001;
 - (ii) A trust for which a charitable deduction was previously allowed, until the termination of all charitable interests; or
 - (iii) A trust created after December 31, 2000 if the trust must vest under the former rule against perpetuities period *unless the trust expressly authorizes nonjudicial modification.*
 - b. Settlor must be deceased.
 - c. Regardless of whether the reasons above under F.S. § 736.04113 are present, the same modifications can be made if the trustee and **all** qualified beneficiaries unanimously agree.
 - d. Any beneficiary may commence a judicial proceeding for review of a proposed nonjudicial modification.

- e. Modification may be achieved despite existence of spendthrift clause or a trust provision that prohibits amendment or revocation of the trust.
 - f. Can use to change provisions or even terminate trust; no statutory limitations on the scope of changes.
2. F.S. § 736.0414(1) - Modification/termination of uneconomic trust.
- a. Trustee can terminate if total value of trust assets is less than \$50,000 and continued administration is, in the trustee's judgment, insufficient to justify administration costs.
 - b. Trust can expressly prohibit termination under this section, but mere existence of a spendthrift provision does not make this section inapplicable.
 - c. Upon termination, trustee must distribute assets in a manner consistent with the purposes of the trust.
3. F.S. § 736.0417 - Combination/division of trust.
- a. Must first provide notice to qualified beneficiaries.
 - b. Can combine multiple trusts into a single trust, or divide a single trust into multiple trusts, as long as the rights of any beneficiary are not impaired, or it does not adversely affect achievement of the purposes of the trust.
 - c. Severed trusts must be treated as separate trusts for all purposes beginning on effective date, which may be retroactive.
 - d. Favorable scenarios for combination/division of a trust include:
 - (i) Original trust has a mixed inclusion ratio. Can split into GST exempt trust and GST nonexempt trust.
 - (ii) Beneficiaries require different investment strategies.
 - (iii) Sever ties between disputing beneficiaries.
 - (iv) Can combine multiple trusts to reduce administrative burden and expenses.

- e. Any beneficiary may commence a judicial proceeding for review of a combination or division.

C. Nonjudicial Settlement Agreement - F.S. § 736.0111.

1. Authorizes the trustee and interested persons to enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust. However, it is valid only to the extent the terms and conditions could be properly approved by the court.
2. Agreement may relate to any trust matter, such as interpretation of a provision, approval of accounting, restricting or expanding trustee powers, trustee appointments or resignations, determination of trustee compensation, trustee liability for a trust action, transfer of principal place of administration.
3. Any person whose interest is affected by the settlement agreement may request court approval or disapproval.

V. Sale of assets to a grantor trust

1. Transaction involves establishing a new grantor trust with desired provisions to purchase the asset(s) from the problem trust for fair market value or can use another preexisting trust with desired provisions. Subject assets are then managed and administered according to the terms of the new grantor trust. Once sale is complete, Trustee may distribute proceeds of sale in the problem trust to or for the benefit of the beneficiaries and then subsequently terminate the problem trust. Such trust distributions may replace payments already being made by the grantor, thereby saving the grantor money which can then be gifted to the new trust.
2. Funding the new trust
 - a. Outright gift of cash to new trust will be subject to gift tax, although trust can be tailored to utilize annual exclusions.
 - b. Initial seeding of new trust does not need to be outright gift of cash. Grantor can loan cash to trust and have trust repay the loan over a given period if the purchased asset will produce income. As long as the terms of the loan provide for an interest rate at least equal to the applicable federal rate, which is usually lower than average market returns, no taxable gift will result from the grantor.
 - c. To reduce the amount of cash up front needed to buy asset, the purchase and sale can be made pursuant to terms providing for a down payment with subsequent installment

payments. Income generated by the purchased asset can be used to make installment payments.

3. Works best with low value assets or life insurance because grantor will not be required to fund a significant amount of cash into new trust to complete the transfer. Further, less cash will end up in the problem trust.
4. Income tax issues
 - a. If the grantor of the purchasing trust is also the grantor of the problem trust, the sale will be ignored and no income tax will result. Rev. Rul. 85-13.
 - b. If the asset transferred is a life insurance policy, the transaction will be treated as a transfer to the insured for purposes of the transfer for value rule, thus avoiding tax once proceeds are paid out. Rev. Rul. 2006-64.
5. Gift, Estate, and GST tax should be avoided as long as asset(s) sold for fair market value.
 - a. If value of asset sold is incorrect, the excess value transferred from the problem trust may be treated as a taxable gift from the beneficiaries of the old trust to the beneficiaries of the new trust. If the beneficiaries between the trusts are substantially the same, then this should not be a problem.
 - b. Basic fiduciary principles should prevent the trustee from accepting less than the fair market value of the transferred asset(s).
 - c. For insurance policies, the gift tax value varies depending on the type of policy and the surrounding circumstances. The value provided by insurance companies on Form 712 may not be appropriate to rely upon in all cases. The Treasury Regulations provide methods for valuing certain insurance policies, including using the cost of a comparable contract or the interpolated terminal reserve plus the unused portion of the last premium paid. However, it may be that the most accurate indicator of fair market value is the policy's life settlement value, especially for insureds who are older and in poor health.
 - d. Treatment of transfer as a taxable gift should generally be avoided, as such could result in possible estate tax

consequences on death of donor, or the loss of GST exempt status.

VI. Tax considerations associated with trust modifications

A. Income Tax

1. The primary concern is to avoid treatment of the modification as a deemed sale or exchange of property among the beneficiaries. A deemed sale or exchange will trigger the realization of gain or loss to each beneficiary under Internal Revenue Code § 1001 if the interest received is materially different from the interest given up. Interests are generally considered materially different if the legal entitlements between the interests differ in kind or extent (ex. present vs. future interests). *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991).
 - a. The modification of a trust resulting strictly from the trustee's exercise of a power authorized under the trust or local law (ex. decanting) should not trigger sale or exchange treatment to the beneficiaries.
 - b. Extreme caution and careful consideration of each beneficial interest before and after the proposed modification is necessary where the beneficiaries are consenting to the trust modification. For example, in a modification pursuant to F.S. § 736.0412, beneficiaries are consenting to the exchange of interests in the old trust for interests in the new trust.
 - c. While generally a distribution to a new trust should not give rise to a recognition event, special treatment may apply where the transferred property is encumbered, or is a partnership or LLC interest with a negative capital account. The liability assumed is generally treated as an amount realized by the party relieved of the liability, potentially leading to taxable gain to the extent that the amount realized exceeds the transferor's basis in the property. However, if both trusts are grantor trusts as to the same individual, then no such issues should arise.
2. If the trust holds stock in an 'S' corporation, improper modification of the trust could impact the trust's status as a qualified shareholder, thereby causing the loss of the trust's Qualified Subchapter S Trust (QSST) status or Electing Small Business Trust status. Ultimately, this could result in the loss of

the corporation's status as an 'S' corporation. Be careful to reelect!

3. When modifying a trust or creating a new trust, one must consider who will be liable for the income tax on the modified or new trust. Consider whether the trust was a grantor trust prior to modification and whether the modified or new trust will be a grantor trust.
4. Most often, a trust modification will not give rise to a recognition event. However, distributions will still carry out a proportionate share of the trust's distributable net income (DNI). Distributing trust will receive a deduction while the recipient trust will receive income.

B. Estate and Gift Tax

1. Estate Tax - a grantor who participates in the modification of a trust opens the door to arguments from the IRS that the grantor has retained a power under Internal Revenue Code §§ 2036 or 2038 which may cause inclusion of the trust assets in the grantor's estate for estate tax purposes. Often, trusts may be drafted to prohibit the grantor from participating either directly or indirectly in any trust modification to avoid the potential of such inclusion.
2. Gift Tax - The IRS may assert that a beneficiary who fails to object to a modification executed solely by the trustee has made an indirect gift to another beneficiary even in situations where the trustee is solely determining the modifications. If the consent of beneficiaries is required for the modification, such as a modification pursuant to F.S. § 736.0412, the risk of a potential gift is even greater.
 - (i) It may be better to have trustee make modifications pursuant to court approval. It is a case by case determination. For example, consider whether an interest as a permissible beneficiary of a sprinkle power is a gift?
 - (ii) To minimize the risk that the IRS may assert that a gift has occurred, the beneficiary could be given a testamentary non-general power of appointment over the new or modified trust. This would make any potential gifts deemed to be made by the beneficiary incomplete for gift tax purposes.

C. GST Tax

1. A GST Exempt Trust can lose exempt status as a result of a modification where the modification causes a shift in a beneficial

interest in the trust to a beneficiary of a lower generation than the original trust beneficiaries, or the modification extends the time for vesting of any beneficial interest beyond the period provided for in the original trust.

2. A shift in a beneficial interest can result from either increasing the amount of a GST transfer, or creating a new GST transfer.
 3. An administrative modification which indirectly increases the amount of a GST transfer will not be considered to shift a beneficial interest in the trust. One example of such a modification would be a reduction in the trustee compensation schedule or a change of trustee.
- D. While administrative rulings, statutes and caselaw provide authority for structuring a modification to minimize adverse tax consequences such as those mentioned above, one should consider obtaining a private letter ruling from the IRS when significant assets or consequences are at stake. It is often the only way to achieve certainty as to the outcome of a modification.

VII. How can trustees protect themselves from liability for the modification/ termination

- A. Document the due diligence - talk to the beneficiaries and other trustees to find out what is in the best interests of all concerned.
- B. Get consents, releases and waivers from **all** qualified beneficiaries, which may include individuals who do not have a present interest. Certain individuals may be able to bind or represent other beneficiaries under the Florida representation statutes.
- C. Seek professional advice on potential tax consequences.