Modifying or Terminating Irrevocable Trusts and Trust Decanting

Some terminology used in the article includes:

(a) The trust “Grantor” is the person who creates the Trust;

(b) The “Trustee” is the person or corporate fiduciary who manages the Trust; and

(c) The “Beneficiary” is the person or group of individuals or entities for whom the trust has been created.

Irrevocable Trusts are often used as a means of transferring wealth to loved ones while also reducing estate tax liability for the Grantor’s estate.

The Grantor not only gives the assets away, but he or she also gives up the right to amend or revoke the Trust, even if circumstances change.

If the Grantor reserved the right to make changes to the trust instrument, the gift would be considered incomplete for tax estate and gift tax purposes, which would defeat the principal tax objectives for the gift to the Trust.

Those prohibitions against changing or terminating irrevocable trusts have been softened in recent years by the terms of the Uniform Trust Code, which allow an irrevocable non-charitable trust agreement to be modified or terminated when appropriate, without the loss of the tax benefits, by two procedures: Modification or Termination by Consent and Modification or Termination by the Court.

We will also discuss a third method, called “Decanting,” in which a Trustee may be able to appoint trust assets to a new trust, often created by the Trustee, with more desirable terms and conditions than the old trust.

MODIFICATION OR TERMINATION BY CONSENT

When the Trust’s Grantor and all the possible beneficiaries of a Trust unanimously agree to modifying or terminating an irrevocable trust with no charitable beneficiaries, the terms of the irrevocable trust instrument may be changed, or the Trust may be terminated, by consent.
This type of modification or termination does not require a court order and can be fairly easy to accomplish, regardless of the proposed changes.

Please note that all the beneficiaries must consent to the changes, and that everyone who might possibly receive trust benefits in the future – even if highly unlikely – is considered to be a beneficiary, and therefore must consent. Otherwise Modification by Consent is not available.

When a Trust is terminated by consent, the trust property is distributed as agreed by the beneficiaries, so it is important that there be a written consent, signed by the beneficiaries, which specifies how the trust assets are to be distributed.

MODIFICATION OR TERMINATION BY THE COURT

If the Trust’s Grantor is deceased at the time of the proposed modification or termination, or if any beneficiary does not consent to the proposed modification or termination, then an irrevocable trust instrument may still be modified or terminated, but in that case, the irrevocable trust must be modified or terminated by a Superior Court judge, following certain procedures.

A Modification or Termination by the Court is not quite as simple as a Modification or Termination by Consent, but it can be accomplished fairly quickly if all the beneficiaries of the Trust agree.

A Petition must be filed with the Superior Court to allow the requested modification or termination. The Court has a little less latitude in modifying a trust by this method than is allowed for a Modification or Termination by Consent.

In a Modification or Termination by Consent, the Trust’s Grantor may permit a modification or termination, even if the modification or termination is inconsistent with a material purpose for which the original trust was written, but with a Modification or Termination by the Court, the rules are slightly different: A trust may not be terminated by the Court, unless the Court concludes that continuance of the trust is not necessary to achieve any material purpose of the trust.

A Modification by the Court, even with the consent of all the beneficiaries, generally may be done only if the Court concludes that the modification is consistent with a material purpose of the Trust.
Even then, there can be a narrow exception, if the Court concludes that the reason for the requested modification “substantially outweighs” the intended material purpose.

Also, if any beneficiaries refuse to consent to a Modification or Termination by the Court, it is still possible to obtain court approval, but in this case, the interests of all non-consenting beneficiaries must be “adequately protected.” Consequently, any non-consenting beneficiary should respond to the Petition and state the reasons for his or her refusal to consent.

In a Modification or Termination by the Court, minor children may be represented by a parent, and unborn beneficiaries may be represented by a lineal ancestor of the unborn beneficiary.

Missing or incapacitated beneficiaries, etc., may be represented by other individuals.

Upon a Termination by the Court, the Trustee shall distribute the trust property as ordered by the Court, in a manner consistent with the purposes of the Trust.

DECANTING

A third alternative, which results in overriding the terms of an irrevocable trust agreement is called “decanting.”

Decanting allows the Trustee of certain irrevocable trusts to “pour over” the assets of the original Trust into a new Trust, with more favorable terms.

Often, Court approval is not required, so decanting can be relatively inexpensive and easy to implement.

Decanting is allowed only if the original trust was created by an irrevocable trust instrument, which gives the Trustee the power to make discretionary distributions of trust assets to or for the benefit of one or more beneficiaries.

Also, the Trustee who exercises the decanting power must not be a beneficiary of the trust.

Decanting may be used to address unforeseen circumstances, such as how to care for a disabled beneficiary, or how to protect a beneficiary with creditor or marital problems.
However, there are limitations as to what the Trustee can do in transferring assets from an existing trust to a new trust: for example, no new beneficiaries may be added, who were not beneficiaries under the old trust instrument.

However, a result somewhat similar to naming a new beneficiary can be achieved in a different manner. A **trust beneficiary may be given a power of appointment** in the new trust agreement, which would enable him or her to appoint trust assets to a person who is not named as a beneficiary in the original trust agreement.

For example, an irrevocable trust instrument may provide that trust income, and principal in the trustee’s discretion, may be distributed to the Grantor’s child for life, and after the child’s death, the trust assets are to be distributed to the Grantor’s grandchildren. In this example the child’s spouse would not be a beneficiary of the trust.

If the trust is decanted into a new trust, the spouse still cannot be named as a beneficiary, but the new trust instrument may give the child, who is the life beneficiary of the trust, a **power of appointment** over the trust assets, whereby the child would be able to appoint the trust assets on his or her death to a person who was not a beneficiary under the original trust instrument.

In that case, the child may choose to appoint the trust assets to his or her spouse, outright and free of trust, or in the alternative, to extend the term of the trust and to make the spouse an income beneficiary, and even to allow the Trustee to make additional distributions to the spouse in the Trustee’s discretion.

Continuing the trust for the spouse’s lifetime would give some protection for the Grantor’s grandchildren, if the spouse remarried, etc.

All three statutory alternatives for changing the original terms of an irrevocable trust agreement which have become inappropriate will require professional assistance, but they can all result in modification of the terms of a trust or termination of a trust which no longer is appropriate.