OUTLINE FOR ALI-ABA PRESENTATION:
FIX-UPS OF ESTATE PLANS AFTER THEY HAVE BECOME IRREVOCABLE
BY: DOMINGO P. SUCH, III

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Introduction

Estate plans go through numerous iterations prior to being finalized. Provisions that were appropriate initially may seem less so when the estate “matures.” Many reasons exist for issues and complications that arise during the administration. Most commonly, changes in the tax law have been problematic, as has been the recent experience with repeal of the federal tax and decoupling of state death taxes. Other issues come from scrivener’s errors, mistakes and changes in circumstances. In order to plan effectively, flexibility is critical. Documents are necessarily complex and the trend of using long-term trusts is likely to increase the number of trusts that will be scrutinized after they have become irrevocable.

Fortunately, as the need for estate plan fix-ups has grown, the range of available techniques has also expanded. The Internal Revenue Service (the “IRS”) seems somewhat accepting of these techniques. This outline explores the different methods currently available for modifying and changing or altering the results of irrevocable trust agreements. Necessarily, state law will impact the terms of the trusts and will need to be examined.

Techniques

I. Mergers

A. A merger of two (or more) trusts allows the merged trusts to be governed by one instrument, which provides convenience in trust administration and allows greater investing opportunities due to the combination of trust assets. The effect of the

merger is to terminate one of the trusts, typically an older irrevocable trust which is merged into a new trust.

B. Requirements

1. Trust law allows the merger of trusts with one another only if the provisions of the two trust instruments are virtually identical, or “substantially similar.”
   a. The following provisions of the merging trusts must be the same to merge the trusts:
      i. Governing law;
      ii. Permissible beneficiaries;
      iii. Standards for distribution to beneficiaries; and
      iv. Maximum lengths of the trusts under the rule against perpetuities.
   b. Differences in these provisions, and possibly others, preclude a merger of two or more trusts.
   c. To ensure that trusts will be able to merge in the future, certain provisions should be drafted the same way for all trusts. For example, by creating perpetual trusts (where possible under local law), the perpetuities period should be identical for all trusts created by a husband and wife. Otherwise, future trust mergers for descendants may not be possible due to the inconsistent perpetuities period.

2. Trust mergers may be more readily accomplished if the trust instruments of the merging trusts permit the trustee to merge the trusts.

   Sample language: The Trustee has the authority “to hold separate trusts under this or other instruments as a common fund in which the trusts have proportionate interests; and to consolidate and merge any trust with any other trust under this or another instrument having the same beneficiaries and substantially the same terms even if segregation is directed elsewhere under this instrument.”

C. Tax Consequences

There can be significant tax implications from the merger of trusts. For example, a merger between two trusts with different perpetuities periods where one trust is exempt from generation-skipping tax (the “GST”) and the other trust is not exempt from GST will result in the loss of the very valuable GST exempt status
for that trust due to the merger. Thus, all distributions from the newly-merged trust to the grantor’s descendants would be subject to GST, no longer having the protection of “grandfathered” status. Note, however, that such an outcome may be avoided by severing the trusts (see Section III-B below on Qualified Severances).

1. Note: A modification of the governing instrument of a GST grandfathered trust by judicial reformation or non-judicial reformation that is valid under applicable state law will not cause the loss of GST grandfathered status if (a) the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification and (b) the modification does not extend the time for vesting of any beneficial interest in the trust beyond the perpetuities period provided for in the original trust.\(^2\) A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.\(^3\)

II. Divisions and Qualified Severances\(^4\)

A. A division of a trust allows a separable portion of trust property to be treated differently from the remaining trust property. This can be done to give favorable tax treatment to one portion of the trust property or to take full advantage of an exemption or credit.

B. Qualified Severances

The Internal Revenue Code (“IRC”) was recently amended to make it clear that severances of trusts can be effective for GST purposes using mixed-inclusion ratios.\(^5\) Under IRC Section 2642(a)(3), if a trust is severed in a qualified severance, the trusts resulting from the severance will be treated as separate trusts thereafter.

C. Caselaw

There are a variety of cases that permit the division of GST exempt trusts into two or more trusts in order to permit one of them to be protected completely from the


\(^3\) Handler, David A., Dunn, Deborah V. & Kirkland & Ellis LLP. “Drafting the Estate Plan Law and Forms.” Volume 1, § 5.05[C][2][d]. 2004.

\(^4\) A useful reference for this section is Fix-Ups for Estate Planning Documents by Carolyn S. McCaffrey, February, 2002.

\(^5\) I.R.C. § 2642(a)(3).