

Trust Me, Your Irrevocable Trust is Modifiable



By Jessica Mering Hardin

An irrevocable trust often offers the dual benefits of reducing the grantor's estate tax liability while simultaneously transferring wealth to loved ones. In return for these benefits, the grantor gives up the right to amend or revoke the terms of the trust. This drawback, however, is not as restrictive as it may seem. The North Carolina Uniform Trust Code provides several different ways for parties to an irrevocable trust to adapt its terms to changed circumstances. If you are the grantor, beneficiary or trustee of an irrevocable trust whose terms are no longer satisfactory, consider whether one of the following strategies may fit your needs.

Modification by Consent

As with so many situations, trust modification is easiest when all the parties agree. Modification or termination of a noncharitable irrevocable trust may be accomplished with a single "consent modification" document if the trust's grantor and all of its possible beneficiaries agree. The grantor and beneficiaries may agree to take any action with respect to the trust's terms — even if that action is oppositional to the trust's purpose.

Example – Husband establishes an irrevocable life insurance trust, naming Wife as Trustee during his lifetime. Under the trust agreement, a trust is established by Husband for Wife upon Husband's death and Husband's brother is Trustee. Upon Wife's death, the trust goes to the children of Husband and Wife. Several years later, it is apparent that Husband's brother is not a good choice as Trustee. Husband, Wife and their children may agree to change the successor Trustee to Wife's sister.

Such straightforward modification is permissible regardless of the proposed changes or the number of beneficiaries involved. Keep in mind, however, that every beneficiary who may receive trust property now or at any time in the future – no matter how remote the possibility – must consent to the proposed action. If even a single potential beneficiary refuses, this consent modification procedure is unavailable. (When a minor or unborn person is a beneficiary, consent on the beneficiary's behalf may often be given by a parent of the minor or a lineal ancestor of the unborn beneficiary.)

Further, as the consent of the grantor *and* all beneficiaries is necessary, a consent modification is possible only while the grantor is alive. If the grantor has died or does not consent to the proposed action, or if one or more beneficiaries does not consent, the parties proposing the action must seek court approval.

A consent modification is best suited to trusts with a modest number of beneficiaries, all of whom are willing to execute the consent modification document in a timely manner. This process may be inadvisable when beneficiaries are not easily located or are so numerous that securing all of their signatures would be difficult or impossible.

Modification with Court Approval

When the grantor cannot – or will not – consent to action proposed by all of the beneficiaries, the court may allow such trust modification or termination. While such an action is necessarily more involved than a consent modification, it is a straightforward and relatively short procedure. Here, all of the beneficiaries – again, no matter how remote – petition the Superior Court to approve their proposed action. Unlike a consent modification, however, a court-approved modification or termination generally may not frustrate a “material purpose” of the trust.

Example – Grandfather creates a trust for Grandchildren that is expressly intended to fund Grandchildren’s college educations. As such, no trust property may be distributed to a beneficiary before he or she reaches age 18. After Grandfather’s death, Granddaughter completes high school and enrolls in college at age 16. All the beneficiaries petition the court to modify the trust to permit distributions for education upon high school graduation. The court will likely approve such modification, as all beneficiaries consent and the action is consistent with the trust’s material purpose of providing college education to Grandchildren.

Example – Mother, who has observed Child’s irresponsible financial behavior and is concerned about Child’s financial decisions upon her death, creates an irrevocable trust for Child’s benefit. The terms of the trust call for monthly distributions to Child of a specific amount for the remainder of Child’s life. Immediately after Mother’s death, Child and all contingent beneficiaries petition the court to terminate the trust. Despite the beneficiaries’ consent, the court will likely deny their petition, as termination of the trust would defeat its material purpose of providing consistent but limited support to Child.

In certain situations, however, the court may approve a proposed modification or termination despite its opposition to the trust’s material purpose. Upon the petition of all beneficiaries, the court may allow a modification or termination that is inconsistent with a material purpose of the trust if the reason for such modification or termination “substantially outweighs” accomplishment of the material purpose.

Example – Uncle creates a trust for the sole and express purpose of funding Nephew’s first home purchase. After Uncle’s death, but before Nephew purchases his first home, Nephew encounters necessary and ongoing medical expenses. Nephew and all contingent beneficiaries petition the court to allow trust distributions for medical treatment. The court will likely approve such modification to the trust as meeting Nephew’s medical needs substantially outweighs the interest in funding Nephew’s first home purchase.

While court-approved modification or termination is smoothest when all trust beneficiaries agree to the proposed action, unanimous consent is not necessary. A modification or termination that the court would approve if all the beneficiaries had consented may be approved when not all beneficiaries will consent as long as the interests of the non-consenting beneficiaries will be “adequately protected.” (When a minor or unborn person is a beneficiary, notice to the beneficiary’s parent or lineal ancestor, respectively, is often sufficient.)

Example – Father creates a trust for the benefit of his five sons, A, B, C, D and E, and names Son A as Trustee of the trust. After father’s death, Son A becomes overwhelmed with his responsibilities as Trustee and desires that Bank serve with him as co-Trustee. Sons A, B, C and D petition the court to modify the trust to allow Bank to serve as co-Trustee with Son A. Son E receives notice of the petition but does not indicate his consent to the court. The modification will likely be approved because the court could have approved the modification had all Sons consented (as the Bank’s oversight would protect trust assets and thus further a material purpose of the trust) and Son E’s interest will be protected despite his lack of consent (as the Bank’s involvement will not reduce his share of trust property or make it more difficult for him to access his share of trust property).

A petition for court-approved modification or termination is especially useful when a grantor has died and the beneficiaries desire to modify the trust in response to changed circumstances. If you are the beneficiary of a trust created by a deceased parent or grandparent and are dissatisfied with, for example, the provisions for asset distribution or trustee succession, consider whether you would like to pursue a petition for modification or termination.

Decanting to Modify Irrevocable Trusts

Modification or termination of a trust effected by consent or approved by the court turn primarily on the desires and actions of a trust's beneficiaries. As of October 1, 2009, however, the North Carolina General Assembly allows the trustee of certain trusts to modify the way a trust is administered by distributing – or “decanting” – trust assets from the original trust to a second trust with more favorable terms. This statutory power allows a single party – the trustee – to modify a trust without court involvement or beneficiary consent.

A trustee may exercise this “special power to appoint” some or all trust assets if three threshold requirements are met. First, the trust currently holding the assets to be distributed – the “original trust” – must have been created by an irrevocable trust instrument. Next, the trustee must have the power to make discretionary distributions of trust assets for the benefit of one or more beneficiaries (although such power may be limited to an ascertainable standard). Finally, the trustee exercising the power may not be a beneficiary of the trust. (But the fact that one trustee is a beneficiary does not prohibit a non-beneficiary co-trustee from exercising the power.)

Once the initial requirements are met, a trustee wishing to decant trust assets must select a trust to receive the assets. This second, recipient trust may be a trust already in existence or may be created by the trustee, the initial grantor or another individual for the express purpose of receiving the original trust assets.

Example – Trust for Daughter and Son becomes irrevocable upon Mother's death. Bank, as Trustee, has power to distribute assets to Daughter and Son in Bank's discretion. Daughter develops a medical condition which qualifies her for government benefits subject to certain income limits. Bank may create a special needs trust for Daughter and appoint Daughter's share of the original trust's assets to the special needs trust in order to protect Daughter's share and allow her to qualify for government benefits.

A trustee's power to decant trust assets to a second trust is subject to certain substantive restrictions. For example, the second trust may include *only* beneficiaries of the original trust but is not required to include *all* beneficiaries of the original trust. Further, the terms of the second trust must not disqualify the trust from certain estate tax deductions and gift tax advantages contemplated by the original trust.

While a trustee need not obtain the grantor's or beneficiaries' consent to decant trust assets, the trustee must provide all “qualified beneficiaries,” as defined in the statute, with notice of the trustee's plans. Each qualified beneficiary must receive written notification – or waive the right to receive such notification – at least sixty (60) days before the proposed distribution that sets forth the terms of the second trust and the effective date of the proposed distribution of assets to the second trust. (Again, when a minor child is a qualified beneficiary, notice to the child's parent is often sufficient.)

A trustee should consider exercising his power to decant trust assets to a second trust when obtaining the beneficiaries' consent is not practicable or, because of certain tax implications, not advisable.

Conclusion

While any proposed trust modification must be weighed carefully and considered in light of the facts at hand, one or more of the above strategies may allow you, as a beneficiary or as a trustee, increased flexibility with respect to an existing trust. Keep in mind, however, that a modification or termination may result in gift, estate, generation-skipping tax, and even income tax, consequences. We look forward to considering these issues with you and assisting you in the modification or termination of an irrevocable trust.

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