

Florida Trust Modification, Reformation and Decanting

By: Brian M. Malec

bmalec@deanmead.com

Dean, Mead, Egerton, Bloodworth, Capouano &
Bozarth, P.A.

Orlando, FL

Overview

- Background
- Reformation vs. Modification
- Alternatives to Reformation and Modification
- Considerations
- Judicial Options
- Nonjudicial Options
- Decanting
- Tax Consequences

Background

- Florida Trust Code (Ch. 736) based in part on Uniform Trust Code.
- Options for reformation or modification derive from the terms of the trust, statutes and common law.
- Certain provisions of the FTC cannot be overridden by the terms of a trust. §736.0105.

Reformation vs. Modification

- Reformation

- Equitable remedy to change the terms of a trust to comply with the original intent of the settlor.
- Typically effective retroactively, but IRS may not accept retroactivity for tax purposes.
- Grounds include a mistake of law or fact, whether in expression or inducement, including a scrivener's error.

- Modification

- Generally, a prospective change to the trust terms for one or more reasons sanctioned under law even though the original provisions of the trust are not inconsistent with the settlor's intent and there was no mistake.

Alternative Solutions to Reformation/Modification

- Sell assets to new trust
- Create entities
- Distribution/buyout of beneficiary's interest
- Trustee's power to adjust between income and principal. §738.104
- Convert to unitrust. §738.1041

Considerations

- Identify purpose/goals
- Read the trust
 - Settlor's intent (generally) controls
 - Mandatory vs. modifiable provisions
- Identify sources of liability for trustee
- Identify interested parties
 - Qualified beneficiaries vs. interested persons
- Are all parties represented?
- What modification avenues are available?
- Taxes
- Is court approval necessary (or prudent)?

Judicial Modification Options

- Not Inconsistent with Settlor's Purpose - §736.04113
- Best Interests of the Beneficiaries - §736.04115
- Achieve Settlor's Tax Objectives - §736.0416
- Uneconomic Trust – §736.0414(2)
- Cy Pres – 736.0413
- Reformation to Correct Mistakes – §736.0415

Not Inconsistent with Settlor's Purpose

- § 736.04113
- Court may modify trust if:
 - Purposes have been fulfilled or become illegal, impossible, wasteful or impracticable to fulfill;
 - Because of unanticipated circumstances, compliance with the trust's terms would defeat or substantially impair a material purpose of the trust; or
 - A material purpose of the trust no longer exists.

Not Inconsistent with Settlor's Purpose

- Unanticipated change in circumstances may include:
 - Beneficiary develops health issues (Special Needs Trust);
 - Trust assets grow or decline significantly in value;
 - Change in tax laws;
 - Change in beneficiary's financial condition;
 - Adoption of an adult by a beneficiary. See Dennis V. Kline, 120 So. 3d 11 (Fla. 4th DCA 2013)
- Material purposes may include:
 - Protection of family wealth from creditors or divorce;
 - Provide a resource for HEMS of a beneficiary;
 - Providing a mechanism for the management of multi-generational wealth;
 - Minimizing transfer tax consequences on the transfer of wealth;
 - Managing wealth for minors.

Best Interests of Beneficiaries

- §736.04115
- Court may modify trust “if compliance with the terms of a trust is not in the best interests of the beneficiaries.”
- Not necessary to show purposes have been fulfilled, become illegal, impossible, wasteful, impractical to fulfill, or a change of circumstances, or a material purpose no longer exists.
- Not available for:
 - Irrevocable trusts created prior to January 1, 2001.
 - Irrevocable trusts created after December 21, 2000 that either have the “old” RAP period (lives in being plus 21 years or 90 years), or expressly prohibit judicial modification.
- “Best interests” is very broad.

Achieve Settlor's Tax Objectives

- §736.0416
- Court may modify a trust in a manner that is not contrary to the settlor's probable intent in order to achieve the settlor's tax objectives.
- Although the state court may approve a modification on the basis that it will achieve the settlor's tax objectives, the IRS generally is not bound by the state court decision.
- Examples of modifications for tax reasons:
 - Code § 2055(e) – qualified reformation of a split interest trust to qualify for the estate tax charitable deduction.
 - Treas. Reg. § 20.2056A-4(a) – reformation to qualify a trust for the benefit of a noncitizen surviving spouse as a qualified domestic trust (QDOT) for estate tax purposes.
 - Take advantage of increased transfer tax exemptions under the Tax Cuts and Jobs Act of 2017.

Uneconomic Trust

- §736.0414(2)
- Court may modify or terminate a trust OR remove a trustee and appoint a new trustee if the court determines that the value of the trust property is “insufficient to justify the cost of administration.”
- Judicial termination provision does not have a monetary threshold.
- Settlor can draft to prohibit or modify the requirements of this section.

Cy Pres

- §736.0413
- Court may modify or terminate a trust “if a particular charitable purpose becomes unlawful, impracticable, impossible to achieve, or wasteful.”
- Often applied where the original charity named in the trust either ceases to exist or loses its tax-exempt status.
- *Christian Herald Ass’n v. First Nat. Bank of Tampa*, 40 So 2d. 563 (Fla. 1949)
 - Testator made a devise of property to Christian Herald Association of New Jersey.
 - Organization was dissolved prior to executing the will.
 - Court applied the cy pres doctrine by vesting title to such property in the Christian Herald Association of New York, which was the successor to the dissolved corporation and had a similar purpose.

Reformation to Correct Mistakes

- §736.0415
- Court may reform the terms of a trust “even if unambiguous, to conform the terms to the settlor’s intent if it can be proven by clear and convincing evidence” that BOTH of the following have been affected by mistake of fact or law, whether in expression or inducement:
 - Settlor’s intent; and
 - Terms of the trust.
- Mistake of expression
 - Occurs when the terms of the trust misstate the settlor’s intention, fail to include a term that was intended to be included, or include a term that was not intended to be included. See Comment to UTC § 415.
- Mistake of inducement
 - Occurs when the terms accurately reflect what the settlor intended to be included or excluded but the settlor’s intent was based on a mistake of fact or law. See Comment to UTC § 415.

Nonjudicial Modification Options

- Combination and Division of Trusts (Merger and Severance) - §736.0417
- Termination of Uneconomic Trust – §736.0414(1)
- Nonjudicial Modification – §736.0412
- Nonjudicial Settlement Agreement – §736.0111
 - Not inconsistent with settlor’s purpose
 - Best interests of beneficiaries
 - Uneconomic trusts
 - Cy pres
- Modification by Unanimous Consent of Settlor and Beneficiaries - Common Law
- Trust Protectors/Trust Directors - §736.0808
- Decanting (Trustee’s Power to Invade Principal) - §736.04117

Combination and Division of Trusts (Merger and Severance)

- §736.0417
- After notice to qualified beneficiaries, a trustee may “combine two or more trusts into a single trust or divide a trust into two or more separate trusts if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trusts.
- Commonly used in connection with other modification provisions.
- Also used in generation-skipping transfer tax planning (qualified severance) and modifications involving QTIP trusts.

Termination of Uneconomic Trusts

- §736.0414(1)
- After notice to qualified beneficiaries, a trustee may terminate a trust if the value of the trust property is less than \$50,000 and the trustee concludes that the value of the trust property is insufficient to justify the cost of administration.
- Termination under this section can be prohibited by including a provision in the trust. Further, the settlor may specify a higher or lower threshold for termination.

Nonjudicial Modification

- §736.0412
- Trust may be modified at any time after the settlor's death upon the unanimous agreement of the trustee and all qualified beneficiaries.
- No justification is necessary.
- Not available for:
 - Irrevocable trusts created prior to January 1, 2001.
 - Irrevocable trusts created after December 31, 2000 that have the “old” RAP period (lives in being plus 21 years or 90 years) *unless* the terms of the trust expressly authorize nonjudicial modification.
 - Irrevocable trusts for which a charitable deduction is allowed until the termination of all charitable interests.

Nonjudicial Settlement Agreement

- §736.0111
- “Interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust.”
- “Interested persons” are defined to mean persons whose interest would be affected by a settlement agreement.
- Nonjudicial settlement agreement is valid only to the extent the terms and conditions could be properly approved by a court.
- §736.0111 effectively converts all judicial modification avenues into nonjudicial modification options.

Modification by Unanimous Consent of the Settlor and Beneficiaries – Common Law

- Derived from Florida common law, not the FTC
- Found in UTC §411
- Trust can be modified or terminated by unanimous agreement of the settlor and beneficiaries, even if a trustee objects.
- Differences with §736.0412 Nonjudicial Modification:
 - During the settlor's life;
 - Trustee consent not required;
 - Available for all trusts, regardless of creation date
- Peck v. Peck, 133 So. 3d 587 (Fla. 2d DCA 2014); Preston v. City National Bank of Miami, 294 So. 2d 11 (Fla. 3d DCA 1974)
- Potential IRC 2036 or 2038 estate tax inclusion issue?

Trust Protectors/Trust Directors

- §736.0808 (copied from UTC §808)
- “The terms of a trust may confer on a trustee *or other person a power to direct the modification or termination of the trust.*”
- “A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of fiduciary duty.”
- Debate as to applicable fiduciary standards.
 - §736.0808 is not a mandatory rule under § 736.0105 and thus, the trust terms can alter.
- June 2017 (NCCUSL) approved Uniform Directed Trust Act.
- *Minassian v. Rachins*, 152 So. 3d 719 (Fla. 4th DCA 2014).

Decanting

- Process by which the trustee appoints or distributes a portion or all of the assets of one trust to one or more other trusts. In effect, a trustee holding a decanting power can modify the terms of a trust by creating a new trust and decanting all of the assets of the existing trust to the new trust.
- At least 25 states currently have decanting statutes.
- Differences between state laws include:
 - Notice requirements;
 - Extent to which the trust terms can be changed in a decanting pursuant to a HEMS power or absolute power;
 - Whether mandatory income interests can be eliminated;
 - The extent to which powers of appointment can be granted or altered.
- Uniform Trust Decanting Act passed by NCCUSL July 2015

Decanting

- Florida Common Law
 - *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940)
 - “The power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than fee unless the donor clearly indicates a contrary intent.”
 - No notice requirements
- Florida Trust Code
 - §736.04117
 - Originally enacted 2007
 - Substantially updated 2018
 - Does not impact ability to engage in *Phipps* decanting

Decanting - §736.04117

| | 2017 Law | 2018 Law |
|--|--|--|
| Absolute Power Distribution | Broad authority, but 2 nd trust may include only beneficiaries of 1 st trust | Broad authority, but 2 nd trust may include only beneficiaries of 1 st trust |
| Fixed/vested Interests | Fixed interest, annuity or unitrust “may not be reduced” | “Vested interest” may not be reduced |
| Ascertainable Standard Distribution | No | Yes, but beneficial interests in the aggregate must be “substantially similar” |
| Power of Appointment | Silent | Absolute – omit, create, modify HEMS – maintain POA |
| Extend Trusts | Silent | Yes |
| Notice Req. | All qualified beneficiaries | QBs, settlor and any person who can r/r the first trustee |
| Tax Protections | Marital / charitable | Expanded (gift, GST, S corp., 401(a)(9), grantor trust) |

Decanting

- Benefits
 - Nonjudicial
 - Flexibility
- Concerns
 - Tax consequences are not settled
 - Liability can linger
 - Lack of case law
 - *Harrell v. Badger*, 171 So. 3d 764 (Fla. 5th DCA 2015)

Tax Consequences of Modifications

- Binding the IRS
 - IRS generally is not conclusively bound by a modification agreement among the parties or a state court ruling approving the modification to which the IRS is not a party.
 - *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967)
 - Federal authorities are not bound by a determination made regarding such property interest by a state trial court. If there is no decision of the highest state court on the issue, then federal authorities must apply what they find to be the state law after giving “proper regard” to the state trial court’s determination and to the decisions of other courts of the state. If, however, the highest state court has ruled on the issue, then it should be followed.
 - Seek a private letter ruling (PLR)
 - Seek a prospective court ruling – See Revenue Ruling 73-142

Case Study 1: Divide and Conquer



The Stark Family





Ned Stark dies but is survived by his wife, Catelyn, and his daughters, Sansa and Arya. Ned leaves a credit shelter trust that provides for discretionary distributions to Catelyn for HEMS during her lifetime, and upon her death, it splits into separate dynasty trusts for Sansa and Arya.



The Credit Trust owns \$1 million of gold, \$2 million of property, and a 100% interest in a sword fighting business (that Arya now manages) valued at \$2 million. Arya, being a gifted businesswoman and Braavosi sword fighter, expects to double the value of the business over the next 5 years, now that she is in control and can teach the art of sword fighting how she wants.

Arya hates the idea that her efforts to enhance the business will benefit Sansa and Sansa's descendants when Catelyn dies.



Sansa is not impressed with Arya's skills and wants nothing to do with the business.

Further, she does not want her future inheritance to be harmed when the business fails. Thus, Sansa is demanding the trustee sell the business.



Upon Catelyn's death, if not before, there is sure to be a fight (a sword fight?) between Sansa and Arya regarding the division of the Trust assets, primarily due to the growth or decline of the business.



What can be done to save the Stark family?



Proposed Solution

Sever the credit shelter trust into 2 trusts and modify-

- Trust 1: For the benefit of Catelyn and, upon her death, Sansa and her descendants.
 - Fund with \$500k of gold and \$2m of property.
- Trust 2: For the benefit of Catelyn and, upon her death, Arya and her descendants.
 - Fund with \$500k of gold and \$2m business.

Benefits of Severance and Modification

- Each Trust has assets worth \$2.5 million
- Only Catelyn, Arya and her descendants will share in the success or failure of the business. The share for Sansa and her descendants is not affected by the performance of the business.
- Each Trust has assets that, with Catelyn's consent, can be independently invested without the consent of the other child.
- Agreement can be made between Catelyn, Sansa and Arya that distributions for Catelyn will be made equally from Trust 1 and Trust 2.

Settlement Options

- Severance
 - Fla. Stat. § 736.0417
- Nonjudicial Modification
 - Fla. Stat. § 736.0412 – Consent of trustee and qualified beneficiaries
 - Fla. Stat. § 736.0111 - Nonjudicial Settlement Agreement to modify the trust in the same manner that a court would under § 736.04113 and 736.04115 may be possible.

Settlement Options (cont.)

- Judicial Modification
 - Fla. Stat. § 736.04113 – Modification because of unanticipated circumstances
 - Dispute has arisen and continuing trust on the same terms would lead to depletion of trust assets on litigation expenses instead of preserving the assets for the benefit of the beneficiaries.
 - Fla. Stat. § 736.04115 – Modification for best interests of beneficiaries
 - Compliance with the existing provisions will lead to further disputes and unnecessary trust administration expenses. It is in the best interests of the beneficiaries to sever the trust into two trusts to avoid further disputes.

Income Tax Considerations

Concern: The exchange of interests by Sansa and Arya could be treated as a sale or exchange under Code § 1001, leading to the recognition of gain or loss.

- Treasury Regulation § 1.1001-1(h)- severance is not a taxable exchange if the severance was permitted by the trust or state law, and any non-pro rata funding is authorized by the trust or state law.
- If non-pro rata funding is not authorized by the trust terms or state law, then the severance generally will be treated as a pro rata distribution of assets followed by a taxable exchange of assets between the resulting trusts.

Income Tax Considerations (cont.)

- Treas. Reg § 1.1001 - 1: *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991)
 - Gain or loss is realized from the exchange of property under Code § 1001 only if the interests exchanged are “materially different either in kind or extent.”
 - The key question is whether the exchanged properties “embody legally distinct entitlements.” Thus, one must compare the legal entitlements of each party before and after the modification to determine if the property exchanged is materially different than the property received.

Estate Tax Considerations

- Should not be a concern as long as the parties are not deemed to have made contributions to the resulting trusts. If a beneficiary is deemed to have made a gift to his or her trust as a result of the severance, then Code § 2036 arguably may apply.

Gift Tax Considerations

Concern: Sansa and Arya could be treated as making a gift to each other by relinquishing their beneficial interest in the other's trust.

- IRC § 2511- Gift is deemed to be made to the extent the modification shifts value from one beneficiary to the other.
- Settlements resulting from a bona fide dispute/litigation should be deemed transfers for full and adequate consideration, and thus, not a gift. See *Ahmanson Foundation v. U.S.*, 674 F.2d 761 (9th Cir. 1981)
 - Intrafamily settlements will not be regarded as a bona fide compromise unless the claims were legitimate and are satisfied, to the extent feasible, on an economically fair basis.

GST Tax Considerations

Concern: The creation of two new trusts could cause the loss of GST exemption that was allocated to the credit shelter trust upon Ned's death.

- Preserve GST upon Severance - Treas. Reg. § 26.2642-6
Requirements of a Qualified Severance:
 - Must be pursuant to state law or trust terms;
 - Effective under local law;
 - Funding must occur within 90 days of severance date;
 - Original trust is severed on a fractional basis; and
 - Resulting trusts must provide for same succession of interests of beneficiaries as the original trust.

GST Tax Considerations (cont.)

- Preserve GST upon Modification
 - Treas. Reg. § 26.2601-1(b)(4)(i)(D) – A modification of the governing instrument of an exempt trust by judicial or nonjudicial reformation that is valid under applicable state law will not cause an exempt trust to be subject to GST tax if:
 - (a) the modification does not shift a beneficial interest in the trust to a beneficiary who occupies a lower generation than the person(s) 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 period provided for in the original trust.

GST Tax Considerations (cont.)

- Preserve GST upon Modification (cont.)
 - Treas. Reg. § 26.2601-1(b)(4)(i)(B) – A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to GST tax if the settlement is:
 - (a) the product of arm's length negotiations, and
 - (b) within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement.

Note: *Although the regulations under Treas. Reg. § 26.2601-1(b)(4) technically apply to grandfathered GST exempt trusts, numerous private letter rulings have applied these standards to trusts that were exempt by the allocation of GST exemption.*

Case Study 2: Decanting



Tywin created an irrevocable trust that provides for distributions to or for the benefit of his daughter, Cersei, and Cersei's descendants, for their best interests. In addition, a disinterested / independent trustee may make distributions for Cersei and Cersei's descendants for their best interests.

The Trust provides that $\frac{1}{3}$ of the Trust assets shall be distributed to Cersei once she reaches age 45, $\frac{1}{2}$ shall be distributed to Cersei once she reaches age 50, and all remaining assets shall be distributed to Cersei once she reaches age 55. If Cersei dies prior to receiving all of the Trust assets, then the balance is distributed outright to Cersei's descendants, per stirpes.



Cersei is currently 43 and has two adult descendants, Joffrey and Tommen.



Tywin did not allocate any GST exemption to the Trust.



The Trust investments have grown larger than Tywin anticipated and he does not want Cersei or her descendants to receive a large distribution of the Trust assets outright at any age.



He has concerns that Cersei, Joffrey and Tommen may lose the motivation to rule the Seven Kingdoms and further the family's wealth if they receive a lump sum distribution from the trust.





Joffrey and Tommen are not happy with the distributions the trustee has been regularly making for Cersei because they feel that “mother doesn’t need the money” and she is wasting it, mostly on security guards.

They are concerned that there will not be any money left for them because Cersei is the only one receiving distributions currently and the entire remaining balance will be distributed to Cersei when she reaches 45/50/55. Therefore, they want to “lawyer up” to get a slice of the pie.

What can be done?



Proposed Solution

- Decant the current trust to one or more new trusts that eliminates mandatory principal distributions at certain ages and ensures assets are earmarked for Joffrey and Tommen.
 - Uniform Trust Decanting Act approved in 2015
 - Fla. Stat. §736.04117
 - At least 25 states have decanting statutes.

General Tax Considerations

- IRS Notice 2011-101 (December 21, 2011) – IRS requested comments regarding the circumstances under which transfers by a trustee of all or a portion of the principal of one irrevocable trust to another irrevocable trust that result in a change in the beneficial interests in the trust are not subject to income, gift, estate or GST taxes.
- IRS has yet to issue final guidance and will not issue private letter rulings in the meantime.

General Tax Considerations (cont.)

- General argument is that decanting should not be a taxable event to the beneficiaries because it is the result of the exercise of a trustee's fiduciary power under state law, not an act by the beneficiaries.
- If the decanting is made in resolution of an actual bona fide dispute, then this should strengthen the position of the beneficiaries to claim that no taxable disposition or transfer occurred for income or transfer tax purposes.

Income Tax Considerations

Concern: The act of decanting could be treated as a deemed sale or exchange under Code §1001 leading to the recognition of gain or loss.

- Decanting from a grantor trust to another grantor trust should not be an income tax event. Rev. Rul. 85-13.
- Decanting from a non-grantor trust to grantor trust should not be an income tax event. See Chief Counsel Advice 200923024; PLR 201730018.

Income Tax Considerations (cont.)

- Decanting from a grantor trust to a non-grantor trust may possibly be an income tax event. See *Madorin v. Commissioner*, 84 T.C. 67 (1985); Treas. Reg. §1.1001-2(c)(5), Ex. 5.
- *Cottage Savings Assoc. v. Commissioner*, 499 U.S. 554 (1991)
 - Compare legal entitlements before and after decanting.

Estate Tax Considerations

- Should not be a concern as long as the settlor does not control the decanting and the parties are not deemed to have made contributions to the resulting trust(s).

Gift Tax Considerations

Concern: A gift may be deemed to be made to the extent the decanting shifts value from one beneficiary to the other.

- The act of decanting is the exercise of a fiduciary power under state law and, thus, the beneficiaries are not voluntarily making any transfers of value between them.
 - What if the beneficiaries fail to object?
 - What if the beneficiaries do not have the legal authority to prevent the decanting?
- Settlements resulting from bona fide disputes/litigation should be deemed transfers for full and adequate consideration, and thus, not a gift.

GST Tax Considerations

- The Trust is currently non-exempt. Prior to the decanting, a generation-skipping transfer would have occurred only if Cersei did not survive to age 55. By extending the Trust term for Cersei's lifetime, however, a generation-skipping transfer will occur at Cersei's death if any assets remain in the trust. Thus, Tywin should consider making a late allocation of his GST exemption to the new trust after the decanting is completed.

GST Tax Considerations (cont.)

What if the trust was GST exempt prior to decanting?

Concern: The transfer of assets from one exempt trust to an entirely new trust may cause the assets to lose their exempt status absent an allocation of additional GST exemption to the new trust.

- The IRS has held in numerous non-binding private letter rulings that, at a minimum, a change that would not affect the GST status of a grandfathered GST exempt trust would similarly not affect the exempt status of trusts that are exempt as a result of an allocation of GST exemption. See e.g., PLR 200839025.

GST Tax Considerations (cont.)

- Treas. Reg. § 26.2601-1(b)(4)(i)(A) – Safe Harbor Requirements to Preserve Exempt Status
 - Either the terms of the trust authorize decanting without the consent of any beneficiary or court, or at the time the exempt trusts became irrevocable, state law authorized decanting without the consent of any beneficiary or court; and

GST Tax Considerations (cont.)

- The terms of the second trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest for a period, measured from the date the first trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus, if necessary, a reasonable period of gestation.
- Postponing or suspending the vesting or absolute ownership of an interest for a term of years that will not exceed 90 years is expressly permitted.

Questions?

By: Brian M. Malec

bmalec@deanmead.com

**Dean, Mead, Egerton, Bloodworth, Capouano &
Bozarth, P.A.**

Orlando, FL