

Pressing the Do Over Button: A Practitioners Perspective on Strategies for Modifying Wills and Trusts After Formation

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I. TAX CONSIDERATIONS UNDERLYING MODIFICATIONS: INCOME AND TRANSFER TAXES

A. Income Taxes

Income taxes have in recent decades been imposed at the Federal level at rates ranging from 35-40% for ordinary income and 15-28% for capital gains. Historically, rates have been as high as 90%. Income taxes are revenue oriented and are paid by virtually everyone (having very minimal thresholds).

1. Individual

Individuals are taxed under Part I of Subchapter A of the Internal Revenue Code ("IRC").

2. Corporations

Corporations are taxed under Part II of Subchapter A of the IRC.

3. Partnerships

Partnerships are taxed under Subchapter K of the IRC.

4. Estates and Trusts

Estates pay income taxes after the death of an individual, and trusts pay income taxes after the transfer of property, under Subchapter J of the IRC.

5. Gifts, Legacies and Distributions

Gifts, legacies and distributions from estate and/or trusts are generally tax exempt. Primary exceptions are:

- (a) Income in respect of a decedent ("IRD")
- (b) Distributable net income ("DNI")
- (c) Gifts to employees

6. Deductions

- (a) Charitable – subject to varying percentage caps of adjusted gross income ("AGI")
- (b) Business – subject to percentage floor of AGI

- (c) Administration – subject to percentage floor of AGI under certain circumstances.

7. State and Local Taxes

Most states and some municipalities impose income taxes at varying rates. Many have no preferential rates for capital gains taxes. Nine states currently impose no income taxes.¹

B. Transfer Taxes

Transfer taxes have, until the last few years, been imposed at the Federal level, at the 55% rate for the last several decades. Historically, rates have been as high as 90%. Transfer taxes are policy oriented and are applicable to gratuitous transfers.

1. Gift Taxes

Gift taxes are calculated on a tax exclusive basis.

2. Estate Taxes

Estate taxes are calculated on a tax inclusive basis.

3. Generation Skipping Transfer ("GST") Taxes

(a) Direct Skips

Direct skips are calculated on a tax exclusive basis.

(b) Taxable Distributions and Terminations

Taxable distributions and terminations are calculated on a tax inclusive basis.

4. Deductions

(a) Marital

The marital deduction has been unlimited for the last several decades. Historically it was limited to 50%.

¹ Alaska, Florida, Nevada, New Hampshire (income tax limited to interest and dividends), South Dakota, Tennessee (income tax limited to interest and dividends), Texas, Washington, and Wyoming

(b) Charitable

The charitable deduction has been unlimited for the last several decades. Historically it was limited to 50%.

(c) Debts/Claims

The deduction for debts and claims is a limited only by reasonableness, but must be supported by consideration.

(d) Administration expenses

The deduction for administration expenses is a limited only by reasonableness, but may be subject to a percentage floor of AGI on fiduciary income tax returns.

(e) Exclusions

From time to time, certain types of assets, such as qualified retirement plan benefits, have been exempt from transfer taxes.

5. Options for Where to Claim Deductions

In the case of certain expenses, there is an option to deduct the expense on either of three of:

(a) Estate Tax Return

(b) Income Tax Return

(c) Decedent's Final Income Tax Return

6. State and local taxes

(a) Estate Taxes

All states impose some kind of estate or inheritance tax.² Those that limit it to the credit for state taxes currently in effect for Federal estate tax purposes currently impose no estate tax.³

² As of June 22, 2015, the 7 States that still have an independent inheritance tax are Iowa, Kentucky, Maryland, Nebraska (County), New Jersey, Pennsylvania, and Tennessee (phases out as of January 1, 2016).

³ As of June 22, 2015, fourteen States and the District of Columbia have a “sop” (or “pick-up”) tax which is equal to what *was* the Federal credit for State death taxes paid (as of 2005, the credit has been

(b) Gift Taxes

Two states (Connecticut and Minnesota) currently impose a gift tax.

(c) GST Taxes

Some states impose a GST tax equal to the credit for Federal GST taxes.

C. Prospects for Tax Reform

In considering any modification to a estate or trust, one has to take into account the prospects for tax reform, and, in particular, future changes to exemptions, rates, and bases for taxation.

II. RETROACTIVE MODIFICATION

A. Reformation Proceedings – to correct tax errors

1. Charitable Gifts

Reformation proceedings to correct errors that would otherwise disqualify charitable split interest trusts are Federally sanctioned (IRC 2055(e)(3)) and will be respected by Internal Revenue Service ("IRS")

2. GST Gifts

Reformation proceedings to correct errors that would otherwise disqualify trusts from being GST exempt are Federally sanctioned (Reg. 26.2654-1(b)(ii), e.g. to split trusts) and will be respected by IRS.

3. Qualified Domestic Trusts ("QDOT's")

Reformation proceedings to correct errors that would otherwise disqualify trusts for noncitizen spouses for the marital deduction

replaced by a deduction). Those States are Connecticut, Delaware, Hawaii (modified "pick-up" tax), Illinois (modified "pick-up" tax), Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Vermont (modified "pick-up" tax), and Washington. Louisiana imposes an estate transfer tax designed to absorb the federal state death tax credit allowable under Section 2011 of the Internal Revenue Code.

are Federally sanctioned (IRC 2056(d)(5)(A)) and will be respected by IRS.

4. Qualified Terminable Interest Trusts ("QTIP's")

Reformation proceedings to correct errors that would otherwise disqualify trusts for the QTIP elections are not Federally sanctioned and will not be respected by IRS.

5. 9100 Relief

Section 9100 relief is generally for botched elections, but with mixed success in the case of QTIP elections.

6. Other

Commissioner v. Estate of Bosch, 387 U.S. 456 (1967) – in the absence of a determination by the state's highest court, only "proper regard," not finality, should be given to interpretations by state courts, provided it was entered by a court in a bona fide adversary proceeding. See

- (a) Estate of Warren v. Commissioner, 981 F.2d 776 (5th Cir. 1993)
- (b) Lake Shore Nat'l Bank v. Coyle, 296 F. Supp. 412 (ND Ill. 1968), rev'd on other grounds, 419 F.2d 958 (7th Cir. 1970)
- (c) Underwood v. United States, 407 F.2d 608 (6th Cir. 1969)
- (d) Schmidt v. United States, 279 F. Supp. 811 (D. Kan 1968)
- (e) Lakewood Plantation v. United States, 272 F. Supp. 290 (DSC 1967)
- (f) United States v. White, 853 F.2d 107 (2nd Cir. 1988)
- (g) Estate of Rapp v. Commissioner, 140 F.3d 1221 (9th Cir. 1998)
- (h) Ahmanson Found. V. United States, 674 F.2d 761 (9th Cir. 1981)
- (i) Estate of Carpenter v. Commissioner, 52 F.3d 1266 (4th Cir. 1995)

- (j) Estate of Brandon v. Commissioner, 828 F.2d 493 (8th Cir. 1987)
- (k) Estate of Hubert v. Commissioner, 101 T.C. 314 (1993), aff'd. 63 F.3d 1082 (11th Cir. 1995), aff'd sub. nom. Commissioner v. Estate of Hubert, 520 U.S. 93.

7. See, also

- (a) Eggleston v. Dudley, 154 F. Supp. 178 (W.D. Pa. 1957), rev'd 257 F.2d 398 (3rd Cir. 1958)
- (b) Piel v. Commissioner, 340 F.2d 887 (2d Cir. 1965)
- (c) Daine v. Commissioner, 168 F.2d 449 (2d cir. 1948)
- (d) American Nurseryman Publishing Co. v. Commissioner, 75 T.C. 271 (1980)
- (e) Estate of Nicholson, 94 T.C. 666 (1990)
- (f) Estate of Kraus v. Commissioner, 875 F.2d 597 (7th Cir. 1989)
- (g) Estate of Rapp v. Commissioner, 140 F.3d 1211 (9th Cir. 1998)

B. Construction Proceedings – to resolve ambiguities

If there is a genuine ambiguity, IRS is more likely to respect a construction proceeding than a reformation proceeding.

- 1. Patent
- 2. Latent
- 3. Tax Apportionment Clauses

The presumed intent behind tax apportionment clauses is to minimize taxes

C. Qualified Disclaimers

Though originally designed simply to permit someone not to accept a gift without incurring gift tax consequences, disclaimers can be used in many circumstances to correct errors.

1. Disqualifying Dispositions

2. Disqualifying Powers

D. Nonqualified Disclaimers

Errors can be corrected, under certain circumstances, by making nonqualified disclaimers as well, though subject to gift tax.

E. Litigation Settlements

1. Probate Contests

Probate contests can often substantially rewrite wills (e.g., convert bequests from in trust to outright).

2. Elective Share Contests

Elective share contests can also rewrite wills, though with either an increase or decrease to taxes.

3. Contests involving conflicting agreements

Agreements typically trump wills. Examples of such agreement include:

- (a) Separation agreements
- (b) Prenuptial agreements
- (c) Shareholder/partnership agreements
- (d) Pledges
- (e) Contracts to make wills

4. In Terrorem Clause Contests

In terrorem clause contests can also rewrite wills, though subject to the risk of forfeiture.

F. Private Letter Rulings

1. Pros

The primary advantage of seeking a private letter ruling is certainty.

2. Cons

The primary disadvantages of seeking a private letter ruling are delay, uncertainty and the possibility of a negative result.

III. PROSPECTIVE MODIFICATIONS

A. Decanting

"Decanting" is the term generally used to describe the distribution of trust property to another trust in order to achieve a variety of favorable tax and non-tax results or address changes in law, issues with respect to trust administration, changed circumstances or error.

1. Bases for Decanting

(a) Trust Instrument

Many trusts contain decanting provisions.

(b) Common Law

Many states have cases that address the question of decanting to a greater or lesser extent where the trustee has absolute power to invade principal.

(c) State Decanting Statutes Passed or Proposed:

	State	Statutory Cite	Effective Date/Status
1.	Alaska	Alaska Stat. §§ 13.36.157-13.36.159 (original § 13.36.157 repealed 9/9/13 and replaced with new 13.36.157-.159)	9/15/98; amended 2006, 9/9/13
2.	Arizona	Ariz. Rev. Stat. § 14-10819	9/30/09; amended 7/20/11
3.	Delaware	12 Del. Code § 3528	6/30/03; amended 6/24/04, 6/27/06, 7/5/07, 7/6/09, 7/13/11, 8/6/13, 8/1/15
4.	Florida	Fla. Stat. § 736.04117	1/1/07
5.	Illinois	760 Ill. Comp. Stat. 5/§ 16.4	1/1/13; amended 7/27/15
6.	Indiana	Ind. Code 30-4-3-36	7/1/10; amended 7/1/14

7.	Kentucky	Ky. Rev. Stat. § 386.175	7/11/12
8.	Michigan	Mich. Comp. Laws § 700.7820a Mich. Comp. Laws § 556.115a Mich. Comp. Laws § 700.7103 (definitions)	12/28/12
9.	Minnesota	Minn. Stat. § 502.851	1/1/16
10.	Missouri	Mo. Rev. Stat. § 456.4-419	8/28/11
11.	Nevada	Nev. Rev. Stat. 163.556	10/1/09; amended 10/1/11, 10/1/15
12.	New Hampshire	N.H. Rev. Stat. § 564-B:4-418 N.H. Rev. Stat. § 564-B; 4-419	9/9/08; amended 10/1/15 7/1/14
13.	New York	N.Y. Est. Powers & Trusts § 10-6.6(b)-(s)	7/24/92; amended 8/17/11, 11/13/13, 7/22/14
14.	North Carolina	N.C. Gen. Stat. 36C-8-816.1	10/1/09; amended 7/20/10, 6/12/13, 10/1/15
15.	Ohio	Ohio Rev. Code § 5808.18	3/22/12; amended 3/27/13
16.	Rhode Island	R.I. Gen. Laws § 18-4-31.	6/23/12; amended 7/15/13
17.	South Carolina	S.C. Code § 62-7-816A	1/1/14
18.	South Dakota	S.D. Codified Laws §§ 55-2-15 through 55-2-21	3/5/07; amended 2008, 2008, 2009, 2011, 2013
19.	Tennessee	Tenn. Code § 35-15-816(b)(27)	7/1/04; amended 7/1/13
20.	Texas	Texas Trust Code §§ 112.071-112.087	9/1/13
21.	Virginia	Va. Code § 55-548.16:1 Code of VA (original enactment) Va. Code § 64.2-778.1 (renumbered as part of consolidation of trust and estate laws)	7/1/12 10/1/12; amended 7/1/14
22.	Wisconsin	Wisconsin Trust Code § 701.0418	7/1/14
23.	Wyoming	W.S. 4-10-816(a)(xxviii)	7/1/13; amended 7/1/15

2. Reasons for Decanting

Reasons for trust decanting include to:

- (a) Update or modify trust provisions
- (b) Improve trust administration or management
- (c) Correct drafting errors
- (d) Address changed circumstances

- (e) Remove unworkable restrictions
- (f) Change provisions relating to trusts powers and succession
- (g) Change trust situs
- (h) Combine or divide trusts
- (i) Achieve tax savings
- (j) GST planning

B. Beneficiary Power of Appointment

If a trust beneficiary has a power of appointment exercisable in further trust under a different document, the trust can be decanted whenever the power is exercisable (i.e. testamentary or inter vivos).

C. Resignation of Disqualified Fiduciaries

The resignation of disqualified fiduciaries can address issues such as the reciprocal trust doctrine, though typically subject to the three year rule.

D. Trust Splitting

Whether authorized by the instrument or by law, splitting trusts can address issues including:

- (a) GST taxes
- (b) S corporation status
- (c) Partial QTIP elections

E. Expanding Special Powers of Appointment

If addressed in the governing instrument, the expansion of special powers of appointment can avoid a flat, maximum rate GST tax and subject the property instead to estate taxes at the rate of the power holder, subject to his or her available exclusion amount and lower brackets.

F. Amending or Revoking Trust

Many times, state law permits irrevocable trusts to be amended when the grantor is alive and all parties are adult and competent.⁴

G. Litigation Settlements

The Settlement of bonafide claims brought against fiduciaries in contested accounting or breach of fiduciary duty actions can substantially rewrite wills and trusts.

IV. SPECIAL CONSIDERATIONS WITH RESPECT TO LITIGATION SETTLEMENTS

A. State Court Concerns

1. Marital Deduction (IRC 2056)

In order for the marital deduction to be allowable, under state law the:

- (a) Interest must “pass from” the decedent
- (b) Property must be included in gross estate
- (c) Property must “pass to” the surviving spouse
- (d) Cannot be a “terminable interest,” unless statutorily excepted
- (e) See
 - (1) Ahmanson, supra
 - (2) Carpenter, supra
 - (3) Brandon, supra
 - (4) Hubert, supra
 - (5) Estate of Agnello v. Commissioner, 103 T.C. 605 (1994)
 - (6) Schroeder v. United States, 924 F.2d 1547 (10th Cir. 1991)

⁴ See, for example, N.Y. Estates, Powers & Trusts Law § 7-1.9.

- (7) Estate of Ransburg v. United States, 800 F. Supp. 716 (S.D. Ind. 1991)
- (8) United States Trust Company v. Commissioner, 321 F.2d 908 (2d Cir. 1963)

2. Charitable Deduction (IRC 2055)

In order for the charitable deduction to be allowable, under state law the:

- (a) Interest must “pass from” the decedent
- (b) Property must be included in gross estate
- (c) Property must “pass to” charity
- (d) Contest must be bona fide
- (e) See

- (1) Bosch, supra
- (2) Ahmanson, supra
- (3) Northern Trust Co. v. United States, 78-1 USTC 13,229 (N.D. Ill. 1977)
- (4) Oetting v. United States, 712 F.2d 358 (8th Cir. 1983)
- (5) Estate of Flanagan v. United States, 810 F.2d 390 (10th Cir. 1987)
- (6) Terre Haute First Nat’l Bank v. United States, 91-1 USTC 60,070 (S.D. Ind. 1991)
- (7) Estate of Burdick v. Commissioner, 96 T.C. 168 (1991), aff’d 979 F.2d 1369 (9th Cir. 1992)
- (8) Estate of Johnson v. United States, 742 F. Supp. 940 (S.D. Miss. 1990)
- (9) Estate of La Meres v. Commissioner, 98 T.C. 294 (1992)

(10) Reed v. United States, 317 F. Supp. 1242 (S.D. Ill. 1970)

B. Tax Treatment of Settlements

1. Marital Deduction

The diversion of property from a spouse increases taxes (and perhaps interest and penalties)

2. Charitable Deduction

The diversion of property from a charity increases taxes (and perhaps interest and penalties)

3. Gift Tax Concerns

The values of interests cannot change measurably (Reg. 25.2512-8). See

(a) Commissioner v. Wemyss, 324 U.S. 303 (1945)

(b) Fehs V. United States, 620 F.2d 255 (Ct. Cl. 1980)

(c) Estate of Anderson v. Commissioner, 8 T.C. 706 (1947)

(d) Estate of Friedman v. Commissioner, 40 T.C. 714 (1963)

4. Income Tax Concerns

IRC 102(a) exempts gifts and inheritances, except:

(a) Income from gifts and inheritances

(b) Gain on conversion or deemed conversion

(c) Compensation

(i) Damages

(ii) Services

(d) IRD

(e) DNI – N.B. periodic payments

(f) See

- (i) Getty V. Commissioner, 913 F.2d 1486 (9th Cir. 1990)
- (ii) Tribune Publishing Co. v. United States, 836 F.2d 1176 (9th Cir. 1988)
- (iii) Lyeth v. Hoey, 305 U.S. 199 (1938)
- (iv) United States v. Gavin, 159 F.2d 613 (9th Cir. 1947)
- (v) Estate of Vincent, T.C.M. 1992-21
- (vi) White v. Thomas, 116 F.2d 147 (5th Cir. 1940)

5. Legal Fees

(a) Fiduciary's Fees

A fiduciary's fees are generally deductible by estate or trust

(b) Beneficiary's Fees

A beneficiary's fees are:

(i) Generally not deductible by estate or trust, except

A. Probate Contests

B. Construction Proceedings

(ii) May or may not be deductible by the beneficiary

(c) For fees to be deductible, they must be reasonable – U.S. v. White, 853 F.2d 107 (2d Cir. 1988)

C. Strategies

The following strategies can be employed to achieve substantial tax savings when modifying governing instruments as part of litigation settlements:

1. Establish consideration
2. Claims against estate or trust: consider

- (a) High valuations
 - (b) Post-death events
- 3. Claims by estate or trust: consider
 - (a) Low valuations
 - (b) Risk of litigation discount
 - (c) Post-death events
- 4. Enhance tax advantaged trusts
 - (a) Estate Tax Exempt Trusts
 - (i) Credit shelter trust
 - (ii) Trusts not in gross estate
 - (b) Estate Tax Deferred Trusts (such as marital trusts)
 - (c) GST Exempt
 - (i) Zero inclusion ratio
 - (ii) Grandfathered
- 5. Consider possible benefits of exercising the right of contribution
- 6. Transfer debt to lower generations
- 7. Create more funds through substantive state elections
- 8. Discount long-term notes
- 9. Consider deducting payments to children
- 10. Buy back assets from charity
- 11. Characterizations of transfers as gifts vs. loans

