

# **FIXING BROKEN TRUSTS**

**Presented to**

**First Annual Estate Planning Symposium of  
The Estate Planning Council of the Emerald Coast, Inc.**

**on**

**August 17, 2007**

**By:**

**Bryan Howard, Esquire  
Howard Mobley & Havens, PLLC  
200 31<sup>st</sup> Avenue North, Suite 100  
Nashville, TN 37203  
(615) 627-4446**

**[bryan@trustestatelaw.net](mailto:bryan@trustestatelaw.net)  
website: [www.trustestatelaw.net](http://www.trustestatelaw.net)**



### **Bryan Howard**

Howard Mobley & Havens, PLLC  
200 31<sup>st</sup> Avenue, North, Suite 100  
Nashville, Tennessee 37203  
615-627-4446  
615-627-4448 (fax)  
bryan@trustestatelaw.net

### **Practice Areas**

- Estate planning
- Tax law
- Estate and trust litigation
- Business succession planning
- Charitable planning
- Estate administration

Bryan Howard is a founding member of Howard Mobley & Havens, PLLC and concentrates his practice in the areas of estate planning, tax law, estate administration, and related business matters.

Bryan is certified as an Estate Planning Specialist by the Tennessee Commission on Continuing Legal Education and Specialization. Bryan is listed in the **Best Lawyers in America** (2001-2007 editions) and was selected as one of the top 100 Lawyers in the U.S. by Worth Magazine in 2006. Bryan has the AV rating (highest available) for ethical standards and legal ability from Martindale-Hubbell's peer review ratings system.

Bryan assists high net worth individual and families with wealth transfer planning, tax reduction planning and asset protection planning. He also advises the owners of closely-held businesses with respect to tax and business succession issues. In addition, Mr. Howard represents fiduciaries and beneficiaries with regard to trust and estate administration and litigation issues.

Bryan frequently lectures and writes on estate planning and taxation topics. He has been quoted in *Forbes*, *USA Today*, *Kiplinger Retirement Report*, *Entrepreneur* and *Best's*. Recent articles include: "Trust Planning In An Uncertain Estate Tax Environment" presented to the 57<sup>th</sup> Annual Tennessee Federal Tax Institute in 2006; "Fixing a Broken Trust" presented to the 28<sup>th</sup> Annual Duke Estate Planning Conference in 2006; and "Installment Sales Involving Non-Grantor Trusts" published in **Estate Planning** in 2005.

### **Education**

- B.S., Business Administration, University of California at Berkeley, 1979
- J.D., Vanderbilt University, 1983
- L.L.M., Taxation, University of Florida, 1984

### **Professional Activities**

- Fellow, American College of Trust and Estate Counsel
- Numerous legislative activities, including, principal draftsman of the Tennessee Investment Services Trust Act of 2007, Member of Committee which drafted Tennessee Uniform Trust Code (2004 and 2007) and Member of Tennessee Bar Association's Probate Study Committee, which reviews and recommends legislation involving trusts and estates in Tennessee
- Former Chairman (1994 & 2006), Estate Planning Committee, Nashville Bar Association
- Former Chairman (2004), Tax Committee, Nashville Bar Association
- Member, Tax and Real Property, Probate and Trust Law sections, American Bar Association

### **Civic and Other Activities**

- Board Member and Former President, Guardianship and Trust Corporation of Tennessee
- President, Board of Trustees, Tennessee Federal Tax Institute.

**FIXING BROKEN TRUSTS**  
**Table of Contents**

	Page
A. Potential Objectives .....	1
B. General Approaches for Fixing Problems .....	2
C. Traditional Methods for Making Modifications.....	2
D. Life Insurance Trusts .....	4
E. Useful Tools Added by Florida Trust Code.....	6
F. Representation of Beneficiaries .....	7
G. Change of Situs .....	8
H. Non-Judicial Settlement Agreements.....	9
I. Modifications and Terminations of Non-Charitable Trusts.....	10
J. Equitable Deviation.....	10
K. Uneconomic Trusts .....	10
L. Correction of Mistakes.....	11
M. Implement Settlor's Tax Objectives .....	11
N. Merger and Division .....	11
O. Decanting Power .....	12
P. Solving Certain Tax Problems .....	14
1. Reducing Estate Tax on a QTIP Marital Trust.....	14
2. Trapping Income Within a Mandatory Income Trust.....	16
3. Can You Convert a Complex Trust to a Grantor Trust?.....	17
Conclusion.....	22

## **FIXING BROKEN TRUSTS**

Clients that are settlors or beneficiaries of pre-existing irrevocable trust agreements can present unique opportunities. These pre-existing trusts often have problems of one kind or another. A skilled advisor can recommend solutions for fixing these problems and/or make recommendations that will enable the trust to more effectively accomplish the client's overall estate planning objectives.

This paper will identify various methods for fixing problems with pre-existing trusts, including several new problem-solving tools that were added by the Uniform Trust Code, which became effective for Florida trusts on July 1, 2007. The paper will also explore opportunities to reduce income and transfer taxes for certain trusts.

### **A. Potential Objectives.**

The most common reason that a client would like to change a trust is due to changed circumstances, such as an unexpected order of death, divorce, reversal of business fortunes, physical or mental incapacity of a beneficiary, or disharmonious family relationships. There might be an opportunity to decrease a beneficiary's income, gift, estate and/or generation-skipping transfer taxes. There may have been a drafting error. There could be administrative provisions that are not ideal and/or successor trustee provisions that the client would like to change.

**B. General Approaches for Fixing Problems.**

There are two general approaches for fixing problems with irrevocable trusts. One approach is to make a modification to the trust. The other approach is to effectuate a change in the administration of the trust.

**C. Traditional Methods for Making Modifications.**

The traditional method for modifying an irrevocable trust has been to request court approval. This technique is often used and will continue to be used even when non-judicial techniques may be available. Trustees and their advisors are likely to continue to seek court approval until there has been more experience with the use of non-judicial techniques. The primary problems with obtaining judicial approval of a trust modification are time and money. A court proceeding generally requires at least a few months and typically more attorneys are involved. Courts want to make sure that all beneficiaries are represented in a court proceeding involving a trust. Most irrevocable trusts have potential contingent remainder beneficiaries who are minors or who are not yet born. In order to make sure that minors and unborn beneficiaries are represented, a court will either appoint a guardian-*ad-litem* to represent these beneficiaries or allow a virtual representative to represent these beneficiaries. Even though the actuarial value of these contingent remaindermen may represent less than 1% of the value of the entire trust, these beneficiaries are legally entitled to have their point of view considered by the court. Even when the guardian-*ad-litem* or virtual representative agrees with the proposed change, extra time and expense is involved.

In addition to the additional time and expense, there is a risk that a court will not approve a trust modification. Courts have traditionally viewed their role as an enforcer of the settlor's intent. Even when the proposed change appears to be good for all of the beneficiaries, courts are sometime reluctant to make a change that is contrary to the settlor's intent. In recent years, there has been a clear trend for courts to allow more changes and to be more flexible.

As long-term trusts have become more popular, attorneys have become more adept at presenting their clients with techniques that build more flexibility into the trust agreement. These techniques include giving certain tax powers to the trustee, granting beneficiaries powers of appointment, allowing trustees to divide, merge or terminate trusts, allowing beneficiaries the right to remove and replace trustees, and appointing a trust protector who is able to amend the trust agreement under certain circumstances. Trust agreements that have these types of provisions are significantly easier to modify without going to court.

Legislatures have increasingly passed statutes that allow certain non-judicial changes and/or more simplified judicial changes to be made to trusts. For example, Tennessee Code Annotated § 35-50-125, which allowed a written agreement signed by a corporate trustee and all of the primary beneficiaries of a trust to construe a provision of the trust, or to reach an agreement regarding any duty, power, responsibility, or action of the trustee.<sup>1</sup>

---

<sup>1</sup> This statute was repealed effective as of July 1, 2004, due to redundancy with the Tennessee Uniform Trust Code.

In response to the clear trend of judges, settlors, and legislatures to allow greater flexibility, the Uniform Trust Code includes several provisions that make it easier to fix a problem without going to court. Before analyzing the UTC provisions, this paper will address another non-judicial method of fixing problems with life insurance trusts.

#### **D. Life Insurance Trusts.**

Life insurance trusts (“ILITs”) seem to have a limited useful life for a lot of settlors.<sup>2</sup> After a few years, the settlor’s overall estate planning objectives often change in a way that makes the existing ILIT less than optimal. If the settlor is still in good health, it may be possible to establish a new ILIT that will acquire a new life insurance policy. If the existing life insurance policy needs to be retained, it may be feasible for the ILIT to distribute the policy to the beneficiaries, who then have the option of doing something different with the policy. An outright distribution often creates other problems. Generally, the client prefers that the policy be owned by a totally new ILIT. This can be accomplished by creating a new ILIT and then having the old ILIT sell the policy to the new ILIT. If the settlor informs the trustee of the old ILIT that he no longer intends to make contributions to the old ILIT, the trustee will generally obtain the best result for the beneficiaries of the old ILIT by selling the policy to the new ILIT. This will capture the existing value of the policy (assuming that it is not a term policy) and

---

<sup>2</sup> This problem is not limited to life insurance trusts, but it seems to occur most often with respect to life insurance trusts.

will eliminate the need for the old ILIT to make future premium payments on the policy.

The transfer for value rule must be avoided if the new ILIT purchases the policy from the old ILIT. When a life insurance policy is purchased, IRC § 101(a) will subject the death proceeds to income taxation unless an exception is found. Internal Revenue Code § 101(a)(2)(B) provides exceptions to the transfer for value rule when the transfer is to the insured, or to a partner of the insured.<sup>3</sup> It is generally advisable to avoid a transfer to the insured, because the insured will then have to transfer the policy to a new ILIT and survive three years after the transfer in order to avoid inclusion of the life insurance proceeds in the insured's estate pursuant to Internal Revenue Code § 2035. Nevertheless, this exception can be useful if the transfer is made to a trust which is treated as a grantor trust as to the insured for federal income tax purposes. Pursuant to the logic of Revenue Ruling 2007-13, I.R.B. 2007-11, and Revenue Ruling 85-13, 1985-1 C.B. 184, the separate existence of the trust is ignored for income tax purposes and a transfer to the trust is treated as a transfer to the insured.

It is relatively easy to make a new ILIT a grantor trust as to the insured. For example, the insured's spouse can be a discretionary beneficiary of the ILIT (Code § 677(a)(1)) unless the policy is a last-to-die policy. Someone other than the insured can have a power to substitute assets of equivalent value for assets held

---

<sup>3</sup> There are other exceptions which are not pertinent to this discussion.

by the trust (Code § 675(4)(C)). The trust can authorize income of the trust to be applied to the payment of premiums on the life insurance policy (Code § 677(a)(3)).

Even though the IRS has ruled that a sale of a life insurance policy to a grantor trust is not a transfer-for-value, the author recommends use of a backup technique. The IRS has created an environment in which one cannot always be certain that a particular trust is a grantor trust.

It is very easy to make the new ILIT a partner of the insured. For this purpose, co-ownership of membership interests in a limited liability company (“LLC”) will suffice. Sometimes the insured will already own a partnership or LLC interest. The insured can transfer a portion of his partnership or LLC interest to the ILIT prior to the sale of the policy from the old ILIT to the new ILIT. If the insured does not own a transferable partnership interest or LLC interest, the insured and the ILIT can each purchase one unit of certain publicly traded partnerships (“PTPs”). Pursuant to Code § 7704, most PTPs are treated as corporations. These PTPs will not help. However, certain PTPs in the natural resources industry are treated as partnerships for federal income tax purposes. Kinder Morgan Energy is the PTP that the author has used for this purpose.

**E. Useful Tools Added by the Florida Trust Code.**

There were several different provisions added by the Florida Trust Code (“FTC”) that facilitate problem solving. These new provisions include:

1. Changing the place of administration of the trust – F.S. § 736.0108(5);(6),(7), and (8)<sup>4</sup>
2. Non-judicial settlement agreements – F.S. § 736.0111;
3. Modification and termination – F.S. §§ 736.0413 and 736.0412;
4. Equitable Deviation - F.S. § 736.0415;
5. Terminating or changing the Trustee of uneconomic trusts - F.S. § 736.0414;
6. Correction of mistakes - F.S. § 736.0415.
7. Modification to accomplish settlor’s tax objectives - F.S. § 736.0416; and
8. Combining and dividing trusts - F.S. § 736.0417;

These provisions involve obtaining the consent of certain beneficiaries or providing notice to certain beneficiaries. In order to facilitate the process of obtaining the consent of beneficiaries and/or providing notice to the beneficiaries, the FTC includes several helpful provisions that allow the beneficiaries to be represented.

**F. Representation of Beneficiaries - F.S. § 736.0301 thru F.S. § 736.0305**

The representation rules allow various individuals to be represented and be legally bound by an agent provided there is not a conflict of interest between the

---

<sup>4</sup> All references to F.S. herein are to the Florida statutes.

agent and the person whom the agent represents. Minors may be represented by their parents. Persons may be represented by their fiduciaries, including conservators, guardians, agents, trustees, and personal representatives. The settlor may appoint a representative in the trust instrument. Persons may also be represented by another person having a substantially identical interest with respect to a question or dispute. For example, an adult remainderman might be able to represent his minor siblings, and minor cousins, and perhaps future descendants of such beneficiary and his or her siblings or cousins.

**G. Change of Situs – F.S. § 736.0108(c)**

The FTC allows a trustee to transfer the trust principal place of administration to another state. This power may be useful in avoiding or reducing state income taxes or otherwise improving the administration of the trust. However, the Uniform Trust Code or a comparable statute must be in place in the state where the trust is currently located in order to use this power. Some states require prior court approval of a situs change for a trust.

A change of situs will not necessarily change the governing law. The trust instrument will often specify the appropriate governing law and whether and how it may be changed. If the instrument is silent, the FTC provides that the trust shall be governed by the law of the jurisdiction where the settlor resides at the time the trust is first created.

**H. Non-Judicial Settlement Agreements - F.S. § 736.0111.**

The FTC provides that interested persons may enter into binding non-judicial settlement agreements with respect to the following matters involving a trust:

1. The interpretation or construction of the terms of the trust.
2. The approval of a trustee's report or accounting;
3. Direction to a trustee to refrain from performing a particular administrative act or the grant to the trustee of any necessary or desirable power;
4. The resignation or appointment of a trustee and the determination of a trustee's compensation;
5. Transfer of a trust's principal place of administration;
6. Liability of a trustee for any action taken under subdivisions (1) through (5) above.

The FTC define the term "interested persons" to mean persons whose interest would be affected by the settlement agreement. A non-judicial settlement agreement may not violate a material purpose of the trust and must include terms and conditions that could be properly approved by a Court.

**I. Modifications and Terminations of Non-Charitable Trusts - F.S. §§ 736.0413 and 736.0412.**

F.S. §736.04113 authorizes the Court to modify or terminate a non-charitable trust if the Court determines that the modification or termination is not inconsistent with a material purpose of the trust.

After the settlor's death, F.S. §736.0412 allows nonjudicial modifications or terminations with the unanimous consent of the Trustee and all qualified beneficiaries.<sup>5</sup>

**J. Equitable Deviation - F.S. § 736.415**

Courts are allowed to terminate trusts or modify the administrative or dispositive terms of the trust due to unanticipated circumstances or the inability to administer a trust effectively. The NCCUSL comments to the UTC provide an example of increasing support distributions to a beneficiary who is unable to support himself due to poor health or serious injury.

**K. Uneconomic Trusts - F.S. § 736.0414.**

After providing notice to the beneficiaries, a Trustee may terminate a trust that holds assets worth less than \$50,000. The Trustee must decide how to

---

<sup>5</sup> This term is defined in F.S. § 736.0103(14) to mean “a living beneficiary who, on the date the beneficiary’s qualification is determined: (A) is a distributee or permissible distributee of trust income or principal; (B) would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in paragraph (A) terminated on that date without causing the trust to terminate; or (C) would be a distributee or permissible distributee of trust income or principal if the trust terminated in accordance with its terms on that date.”

distribute the assets among the beneficiaries based upon the settlor's intention. Furthermore, a Court may change the Trustee of an uneconomic trust.

**L. Correction of Mistakes - F.S. § 736.0415**

A court is allowed to reform a trust to conform to the settlor's intention when there was a mistake of fact or law. Correction of scriveners' errors will be the most likely use of this statute.

**M. Implement Settlor's Tax Objectives – F.S. § 736.0416**

A court may modify a trust to implement a settlor's tax objectives. Assume a Crummey trust drafted in 1995 limits the withdrawal rights for each beneficiary with respect to additions to the trust to \$10,000 per year. Since it is likely that the settlor intended to limit withdrawal rights to the maximum permissible gift tax annual exclusion, the Court could increase the annual withdrawal rights to \$12,000 per beneficiary for 2007 and higher amounts in future years as the annual exclusion amount increases.

**N. Merger and Division - F.S. § 736.0417**

A trustee can combine two or more trusts or divide a trust into multiple trusts after notice to qualified beneficiaries. The combination or division must not impair the rights of any beneficiary or adversely affect the achievement of the purposes of the trust. The NCCUSL comments provide that non-identical trusts

may be combined. The comments also provide that divided trusts may be dissimilar as long as the purposes of the trust may still be achieved.

**O. Decanting Power**

Tennessee, New York, Delaware, and Alaska have enacted statutes that allow a trustee who has discretion to distribute corpus to a beneficiary to exercise the power by distributing corpus to another trust that benefits the same beneficiary.<sup>6</sup>

The Tennessee, Alaska and Delaware statutes apply even when the discretionary distributions are limited by an ascertainable standard, whereas New York's statute only applies when the Trustee's discretion is not limited. For example, Tennessee Code Annotated §35-15-816 (27) provides:

Unless the terms of the instrument expressly provide otherwise:

(A) A trustee who has authority, under the terms of a testamentary instrument or irrevocable inter vivos trust agreement, to invade the principal of a trust to make distributions to, or for the benefit of, one or more proper objects of the exercise of the power, may instead exercise such authority by appointing all or part of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created or under the same instrument; provided, however, that the exercise of such authority:

---

<sup>6</sup> Florida common law may permit a similar result. In Hubert B. Phipps v. Palm Beach Trust Company, 196 So. 299 (Fla. 1940), the trustee had sole discretion to sprinkle income and principal among a class of beneficiaries. The trustee exercised the power by distributing the trust property to a new trust. The court approved the distribution, stating: "An examination of the trust indenture in this case leaves no doubt of the power of the individual trustee to create the second trust provided one or more of the descendants of the donor of the original trust are made the beneficiaries." *Id.* at 301.

(i) Does not reduce any fixed income interest of any income beneficiary of the trust; and

(ii) Is in favor of the proper objects of the exercise of the power;

. . .

This power may be used to correct a lot of problems, including: dealing with changed circumstances; modifying administrative provisions; altering successor trustee provisions; extending the termination date of trusts (for non-tax reasons); correcting drafting errors; converting a trust to a grantor trust or a non-grantor trust; changing the governing state law of the trust; dividing trust property to create separate trusts; and reducing potential liability.<sup>7</sup>

Example – Trust #1 pays all income to A. The Trustee has discretion to distribute principal to A. At age 35, Trust #1 terminates in favor of A.

- Problem – At age 34, A has substance abuse, creditor, and marital problems.
- Solution – Trustee (or A's parent) creates Trust #2 which is similar to Trust #1 except that it terminates in favor of A at age 45. Trustee distributes corpus of Trust #1 to Trust #2 prior to A's 35<sup>th</sup> birthday.

What if you are advising beneficiaries or Trustees of a trust that is a decanting candidate but is not administered in a decanting state? First, check the trust agreement to see if a change of the place of administration changes the governing law. The author has assisted several out-of-state clients who move an

---

<sup>7</sup> Halperin, Decanting Discretionary Trusts; State Law and Tax Considerations, 29 Tax Mgmt. Est., Gifts & Tr. J. \_\_\_ (Sept. 9, 2004).

existing trust to Tennessee, and then decant to a new trust administered where the old trust originated. The trust agreements provided that changing the situs of the trust to another state also changed the governing law. As mentioned above, if the agreement is silent on changing the governing law, a change of trust situs will not change the governing law. Florida trusts may be to use a non-judicial settlement agreement to change the governing law.<sup>8</sup>

When exercising the decanting power, be wary of GST issues.<sup>9</sup>

**P. Solving Certain Tax Problems.**

1. Reducing Estate Tax on a QTIP Marital Trust.<sup>10</sup>

a. Purchase fractional interest in residence from surviving spouse. A surviving spouse might sell a fractional interest in real estate to a QTIP Trust of which the spouse is the income beneficiary. The spouse and the QTIP Trust will both be subject to estate taxes upon the death of the spouse. The tax objective of the sale is to create fractional interest discounts for both the interest that is sold and the interest that is retained by the spouse. Pursuant to the Bonner<sup>11</sup> line of cases, the interests owned by the spouse and the QTIP Trust are not aggregated for estate tax purposes. Spouses favor this technique apart from tax reasons because it increases their liquid assets held outside of the QTIP Trust.

---

<sup>8</sup> See H above.

<sup>9</sup> See Halperin, *supra* for an excellent analysis of these issues.

<sup>10</sup> These techniques may also be utilized for nonmarital trusts that will be subject to generation-skipping trusts upon a beneficiary's death.

<sup>11</sup> Estate of Bonner, 84 F.3d 196 (CA-5, 1996).

Alternatively, the spouse may sell to a QTIP Trust enough stock of a closely-held corporation to go from a controlling position to a non-controlling position.

When an individual sells an interest in a personal residence, Internal Revenue Code Section 121 allows the seller to exclude \$250,000 of gain (or \$500,000 if the Seller is married), even when the sale involves a fractional interest in the residence.<sup>12</sup>

b. Invest in a family limited partnership. In Private Letter Ruling 199920016, the IRS concluded that a QTIP Trust's contribution of marketable securities to a family limited partnership in exchange for a limited partnership interest did not constitute a disposition of the surviving spouse's life estate that would trigger gift tax under Section 2519. The QTIP Trust may owe less estate tax upon the death of the surviving spouse because the fair market value of the limited partnership interest should be less than the fair market value of the assets contributed to the limited partnership.

c. Sell trust assets to children or credit shelter trust for a low interest note. A QTIP Trust might sell some of its assets to the children or a credit shelter trust in exchange for an installment note bearing interest at the lowest rate allowed by the IRS.<sup>13</sup> Installment sales can provide a benefit if the cash flow from the purchased asset exceeds the interest expense on the note. This will permit the purchaser to amortize the principal portion of the debt with cash flow

---

<sup>12</sup> See Treasury Regulations Sections 1.121-4(e)(1) and 1.121-4(e)(3).

<sup>13</sup> For a detailed analysis of this technique, See Howard, "Installment Sales Involving Non-Grantor Trusts" published in **Estate Planning** in February of 2005

from the purchased assets. Another potential advantage of the sale is that the value of the asset involved in the sale transaction is frozen at its value on the date of the sale. Any post-sale appreciation of the asset will not be subject to estate taxes. In the case of highly appreciating securities, real estate, or interests in closely held businesses, this tax savings can be substantial.

## 2. Trapping Income Within a Mandatory Income Trust.

Some beneficiaries of mandatory income trusts prefer not to receive the trust's income. Assume the beneficiary is independently wealthy, is in the top income tax bracket, and is a beneficiary of a trust that will pass outright or in further trust for the beneficiary's descendants upon his or her death without being subject to estate tax or generation-skipping transfer tax. The beneficiary would prefer that income stay within the trust where it will not be subject to estate or generation-skipping transfer tax upon the beneficiary's death. The solution is for the trustee to transfer the trust assets to a single member LLC owned by the trust. The LLC will only distribute enough cash to enable the trust to pay income taxes and Trustee's fees. Trust accounting income will be minimal and the client will not receive unwanted distributions.

A further refinement of this technique is for the beneficiary to sell an asset to the LLC in exchange for an installment note with a low interest rate. The LLC can use the income from its existing assets and the purchased asset to make payments on the note. This will allow the beneficiary to still have access to the cash, yet reduce other assets that will be taxed in the beneficiary's estate.

### 3. Can You Convert a Complex Trust to a Grantor Trust?

There are a variety of tax benefits that may be realized by establishing a new trust as a grantor trust. These same benefits may apply to certain beneficiaries if their trusts are treated as grantor trusts as to the beneficiaries. A few of these benefits are:

- a. The beneficiary may pay less income tax than the trust on accumulated income;
- b. Income tax reporting is simplified;
- c. The beneficiary can make a tax-free gift by paying tax on income that is accumulated for future generations and/or currently distributed to such beneficiaries;
- d. The beneficiary can sell an appreciated asset to the trust without incurring tax;
- e. The Code Section 121 exclusion will be available if the trust owns the beneficiary's primary residence;
- f. The trust may sell appreciated assets to the beneficiary which will get a new basis upon the beneficiary's death; and
- g. The trust will be an eligible shareholder of a Subchapter S corporation without having to make a QSST or ESBT election.

Code Section 678(a)(1) treats a person as the owner of any portion of a trust with respect to which such person “has a power exercisable solely by himself to vest the corpus or the income therefrom in himself”. Consider a credit shelter trust of which the surviving spouse is the trustee and primary beneficiary, or a trust for a child of which the child is the primary beneficiary and trustee. Assume the trust gives the trustee discretion to distribute income to the primary beneficiary for his or her health, education, maintenance, or support. Is this a power exercisable solely by the beneficiary/trustee? Most commentators believe that the ascertainable standard limitation on distributions means that the power is not exercisable solely by the beneficiary/trustee. Their conclusion is based primarily on the legislative history<sup>14</sup> and the case of United States v. De Bonchamps, 278 F.2d 127 (9<sup>th</sup> Cir. 1960), which involved a life estate in which the life tenant had the power to “consume, use, invest and reinvest her share and the income therefrom, for her needs, maintenance and comfort during her lifetime without restriction.”

The Court of Appeals states as follows:

We have concluded that, upon the record before us, the powers of these life tenants are not the equivalent of a power to vest in themselves the corpus of the estate or the capital gains in question. A life tenant under these testamentary provisions may not in any manner control the disposition of the corpus save by consuming it for the enumerated purposes. She may not give it away nor make testamentary disposition of it. She has no power of appointment. She may not change the beneficiaries nor reapportion their shares.

---

<sup>14</sup> S. Rep. No. 1622, 83 Cong., 2d Sess. 87 (1954) states that Section 678 treats a beneficiary as the owner of the trust “if he has an unrestricted power to take the trust principal or income.”

Nor has any one of these life tenants the unlimited power to take the corpus of the estate to herself. Her power to consume is expressly limited to her needs, maintenance and comfort. Nor may it be said that the boundaries of such power as so expressed are so vague as to constitute no real limitation upon the power to consume.

Though the author acknowledges that the issue is unclear, he interprets “solely” to mean that the beneficiary is the sole Trustee of the trust without any person having an explicit veto power regarding distributions made to the Trustee. Accordingly, the author generally recommends that such trusts be treated as Section 678 Trusts. There are several reasons for the author’s interpretation of Code Section 678(a)(i). First, interpreting the word “solely” to mean “solely without ascertainable standards” is a strained construction. Second, when Congress drafted subpart E of subchapter J of the Internal Revenue Code, it knew how to condition grantor trust treatment on the presence or absence of an ascertainable standard. See Code Section 674(b)(5)(A) and Code Section 674(d). It is illogical to conclude that Congress intended for 678 grantor trust treatment to depend upon whether or not distributions are limited by an ascertainable standard when it has demonstrated that it knows how to draft for this result and chose not to draft Code Section 678 in this fashion. Third, state law differences between a life estate and a trust make De Bonchamps a questionable precedent for analyzing a discretionary trust. A life tenant does not own a fee interest. As pointed out by the Court in De Bonchamps, the only way for a life tenant to defeat the remainderman’s ownership interest in a particular asset is to consume the asset. On the other hand, a Trustee legally owns a fee interest in trust assets and can

eliminate the remainderman's interest in a particular asset by distributing the asset from the Trust to the Trustee as beneficiary. If the beneficiary chooses not to consume the distributed asset, the remainderman will not have a legal interest in the asset. The remainder beneficiary would potentially have the legal right to sue the Trustee for a breach of trust by making a distribution in excess of the standard permitted by the trust agreement. If the remainder beneficiary was successful in this endeavor, the likely remedy would be money damages against the Trustee (or the trustee's estate) as opposed to giving the remainderman a legal interest in the particular asset that had been distributed. The author is not aware of any cases that have applied the De Bonchamps' analysis to an actual trust. Fourth, even if a court were inclined to apply De Bonchamps to an actual trust, the result may well be different in a case where the beneficiary/trustee has a testamentary limited power of appointment. In De Bonchamps, the Court found it important that the life tenant had no testamentary power of appointment. Finally, there is some contrary authority to De Bonchamps. In Townsend v. Commissioner, 5 T.C. 1380 (1945) the beneficiary could have withdrawn money from the trust for her support. The Court held that the beneficiary was the owner of the portion of the trust that she did not withdraw under a predecessor code section to Section 678. In PLR 8211057, a beneficiary/trustee had the annual ability to withdraw principal for her "support, welfare and maintenance" up to the amount by which the annual income was less than \$100,000. The ruling held that because the beneficiary was the "sole trustee" she was treated as the owner of the portion of the trust that she elected not to appoint to herself, under Code Section 678(a).

If you want to classify an existing trust as a Section 678 Trust and the beneficiary is not the sole Trustee, you may be able to change Trustees under the terms of the trust agreement or by using one of the trust modification tools discussed above. Of course, making the beneficiary the sole Trustee will often be inappropriate, for various reasons.

When it is not possible to obtain grantor trust status under IRC Section 678(a)(1), it may be possible to obtain grantor trust treatment as to the beneficiary under IRC Section 678(a)(2), which provides that a beneficiary can be treated as the trust owner if she partially releases a withdrawal power, and retains a power over the trust that triggers the grantor trust rules of Sections 671 through 677, had the beneficiary been the trust grantor. Two common examples of this provision are lapsed “Crummey” and “5 and 5” withdrawal powers. Numerous commentators have argued that a lapse of a withdrawal power is not a release and should not trigger IRC Section 678(a)(2). The IRS has consistently disagreed.<sup>15</sup>

A lapsed power of withdrawal will generally not make the entire trust a grantor trust. Each year that the beneficiary does not exercise a withdrawal power, the beneficiary will be treated as the owner of an increasing portion of the trust.

---

<sup>15</sup> See the following private letter rulings in which the IRS treats a beneficiary who allows such a power of withdrawal to lapse as the owner of the trust. PLRs 200104005, 200022035, 20011058, 20011054-200011056, 199942037, 199935046, 9809004-9809008, 9739026, 9232013, 9226037, 8827023, 8813039, 8809043, 8805032, 8517052, and 8521060.

## **Conclusion**

Practitioners now have a number of tools to help their clients get better results from their trusts. Creative restructuring will often be required in order to take advantage of these opportunities. Helping clients to unlock the full potential of their existing trusts can be a very rewarding experience.