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Estate & Succession Planning Corner

Important Guidance on Trust Modifications

By Lawrence I. Richman

It is not uncommon for beneficiaries to seek the benefit of a state court modification, reformation or construction proceeding. Our local courts are an effective way to correct a scrivener's error, reflect a change in the law governing a trust, clarify the rights of a beneficiary under a trust agreement or construe the meaning of an ambiguous phase. As planners, we need to take into consideration an important party absent from such proceedings, namely the Treasury Department. The absence of the IRS means that the consequences of any court proceeding for federal gift, estate and generation-skipping transfer (GST) tax purposes will not be part of a state court order.

Given the importance of transfer tax consequences, however, on many occasions trustees will make a state court order contingent upon the receipt of a supporting private letter ruling from the IRS. But are such private letter rulings always necessary?

Consider, for example, Rev. Rul. 73-142[1] in which the IRS described a trust which reserved to the transferor/grantor of an irrevocable trust for the benefit of his wife and children "the unrestricted power to remove or discharge the trustee at any time and appoint a new trustee, with no express limitation on so appointing himself."[2] The trust agreement included a power in the trustee to withhold payments of income and distributions of principal and to apportion income and principal notwithstanding any contrary rules of law. Had the grantor/transferor died without taking any court action to construe (1) the trustee removal/replacement provisions or (2) the powers of the trustee with respect to the distribution and allocation of the income and principal, the trust would have been included in the transferor/grantor's estate under Code Secs. 2036 and 2038: specifically, (a) Code Sec. 2036(a)(2), which states that a decedent's gross estate includes property with respect to which the decedent "has retained for his life the right … to designate the persons who shall possess or enjoy the property or the income therefrom,"[3] and (b) Code Sec. 2038 which states that a decedent's gross estate includes property with respect to which the enjoyment thereof was subject at death "to any change through the exercise of

a power (in whatever capacity) by a decedent alone or in conjunction with any other person to alter, amend, revoke or terminate."[4]

Under the facts in the revenue ruling, a non-adversary proceeding occurred in which the grantor/transferor petitioned a lower state court during his lifetime to construe the language in the trust agreement. That petition resulted in the court ruling that the decedent's power to remove and replace the trustee was allowed to him only once during his lifetime and that such power did not include the power to appoint himself as trustee. In accordance with and subsequent to the local court order, the decedent did remove and replace the trustee. Thus, as of the date of his death, the decedent retained no powers either alone or in conjunction with any other person to remove and replace the trustee or to affect the allocation or distribution of the income and principal of the trust.

A revenue ruling issued over 45 years ago and a private letter ruling released earlier this year demonstrate the continuing vitality and importance of orders issued by local courts in construing, reforming and modifying trust agreements.

The ruling explicitly states that the holding of the lower court is contrary to decisions of the state's highest court. The ruling also specifically states that the state's highest court would not have so construed the decedent's powers under the trust agreement and in so stating, refers to the holding in *H.J. Bosch Est.*[5] which held that in determining the tax consequences of a trust, the IRS is bound by the rulings of the highest court of the state or its determination, after giving due regard to decisions of other courts of the states, of how the highest court would rule in the absence of an actual ruling. Significantly, Rev. Rul. 73-142 states that *Bosch* "does not in any way indicate that a lower court decree that is inconsistent with the ruling by the State's highest court on the particular issue is void as between the parties to the action."[6] Thus, a final judgment by a lower court is binding upon the parties to the decree and under the facts of the revenue ruling since the decedent's powers were "effectively cut off"[7] by the lower court's decision the decedent did not possess a Code Sec. 2036 or 2038 power at his death.

The net effect of the IRS's ruling is that if a court decision regarding the rights of any party to a trust agreement is binding on and final with respect to such party prior to the occurrence of the taxable event then for transfer tax purposes such judgment is binding on the IRS.

A more recent interpretation of the transfer tax consequences of a lower court's reformation of trusts modified to correct scrivener's errors and to clarify a provision in the trusts was released in May 2019 as LTR 201920001. The trusts at issue were for the benefit of the grandchildren of the transferor/grantor and included for each grandchild a broad testamentary power of appointment without any limiting language. The breadth of the language was such that at death the beneficiary could appoint the trust estate to any person including the beneficiary's creditors. Without a reformation, the beneficiary's power constituted a taxable general power of appointment which was a tax result represented as being contrary to the grantor's intent. Accordingly, the trustee petitioned to reform the trusts to prohibit the "appointments of assets to a beneficiary, such beneficiary's estate trust, the creditors of such beneficiary and the creditors of such beneficiary's estate."[8] Furthermore, based on affidavits from the grantor/transferor's accountant, law firm and trustee, the court further modified the testamentary powers of appointment such that they could be exercised only in favor of the descendants of the parent of the beneficiary, excluding such beneficiary, such beneficiary's estate or the creditors of either.

In addition, the relevant trusts included a withdrawal rights that was not limited by any dollar amount. The court was requested to and did modify the trusts so that the withdrawal rights were limited under Code Secs. 2514(e) and 2503(b) so that the non-exercise of the beneficiary's rights to withdraw would not be a release of a general power of appointment and that the amount subject to such withdrawal right would not exceed the amount that would qualify for the annual exclusion from gift tax.

Unlike in Rev. Rul. 73-142 where the ruling of the lower court was found by the IRS not to be consistent with applicable state law that would be applied by the highest court of the state, in LTR 201920001 the IRS reached the opposite conclusion, ruling that based upon the State's statutes governing trusts the state's highest court would reform and modify the trusts in the manner approved by the lower court thereby enabling the IRS to rely upon *Bosch Est.*[9] in approving the reformation, construction and modification of the trusts.

A revenue ruling issued over 45 years ago and a private letter ruling released earlier this year demonstrate the continuing vitality and importance of orders issued by local courts in construing, reforming and modifying trust agreements. The ability to invoke the power of our local courts is an important adjunct to effective planning.

Lawrence I. Richman is chair of Neal Gerber Eisenberg's Private Wealth Services practice group. Larry is a frequently published author and speaker, and it has been his privilege to be the Estate and Succession Planning columnist of the *Journal of Passthrough Entities* for more than 16 years. During those more than 16 years, Larry's columns have focused on timely commentary and innovative thinking. He has written on topics such as (1) the ways in which disregarded entities can address management and distribution issues for S corporations, (2) the treatment of charitable contributions under Subchapters J and K, (3) private trust company planning and structuring, (4) trust decanting and (5) tax and property law issues affecting generation-skipping transfer tax planning. In his practice, Larry facilitates successful legal strategies for entrepreneurs, tax-exempt organizations, fiduciaries and high-net worth families and individuals. Larry's clients face singular challenges: planning for succession, constantly evolving estate and tax planning regulations, generation-skipping taxes and complex family issues. His work involves estate, gift and charitable planning issues, including business succession, tax-efficient ownership structures, sophisticated tax-exempt structures, trust and estate administration, executive benefits, life insurance and international estate planning for wealthy individuals. Larry is nationally recognized for his ability to conceptualize effective methods that enable family offices and wealthy individuals to make well-informed business and legal decisions at every level of their operations. Attorneys, businesses, families and entrepreneurs all over the country retain him to provide a second opinion on sensitive or high-exposure matters not only because of his extensive experience in estate and trust and tax law, but also his experience dealing with the complex factors that motivate the affluent in managing their business and personal affairs. Larry has served as chairman of the Trust Law Committee of the Chicago Bar Association and is a fellow of the American College of Trust and Estate Counsel, where he serves on its Business Planning and Fiduciary Income Tax Committees. He matriculated *magna cum laude* and Phi Beta Kappa from Columbia University and earned his J.D. from The University of Chicago Law School.

ENDNOTES

1 Rev. Rul. 73-142, 1973-1 CB 405.
2 *Id*.
3 Code Sec. 2036(a)(2).
4 Code Sec. 2038.
5 *H.J. Bosch Est.*, SCt, 67-2 USTC ¶12,472, 387 US 456.
6 Rev. Rul. 73-142, 1973-1 CB 405.
7 *Id*.
8 LTR 201920001 (May 17, 2019).
9 *Bosch Est.*, SCt, 67-2 USTC ¶12,472, 387 US 456.