ACTEC 2019 Annual Meeting Musings

May 2019

The American College of Trust and Estate Counsel is a national organization of approximately 2,500 lawyers elected to membership. One of its central purposes is to study and improve trust, estate and tax laws, procedures and professional responsibility. Learn more about ACTEC and access the roster of ACTEC Fellows at **www.actec.org**.

This summary reflects brief highlighted individual observations of Steve Akers from the seminars at the 2019 Annual Meeting and does not purport to represent the views of ACTEC as to any particular issues.

Steve R. Akers

Senior Fiduciary Counsel
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

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Important Information Regarding This Summary
This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

Introduction

Some of my brief observations from the 2019 ACTEC Annual Meeting Seminars in La Quinta, California on March 22-24, 2019, are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues from some (but not all) of the seminars. The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-13 are observations from a seminar by Susan T. Bart, Mickey R. Davis, and Dana G. Fitzsimons, Jr., Hot Topics

1. Highlights of Changes Made by Section 199A Final Regulations

A few of the many (generally taxpayer-friendly) changes made by final regulations under §199A include the following:

(1) Property contributed to a partnership or S corporation will have an unadjusted basis immediately after acquisition of "Qualified Property" (UBIA) based on the transferee's unadjusted basis in the contributed property (less money received by the transferee or plus money paid by the transferee in the transaction) (i.e., the UBIA will not be reduced by depreciation or other adjustments to basis after the property was acquired and before it was contributed to the partnership or S corporation);

(2) Replacement property received in a like-kind exchange will have a UBIA based on the transferee's unadjusted basis in the relinquished property (i.e., the UBIA will not be reduced by depreciation or other adjustments to basis after the relinquished property was acquired and before it was exchanged) but "decreased by excess boot or increased by the amount of money paid or the fair market value of property not of a like kind to the relinquished property" and the portion of the replacement property having UBIA greater than that of the relinquished property will be treated as separate property placed into service on the date that the replacement property is placed into service;

(3) If a §754 election is in effect, §743(b) basis adjustments (at the death of a partner or upon the sale of a partnership interest) are treated as qualified property to the extent that the adjustment reflects an increase in the fair market value of the underlying qualified property);

(4) The attribution rule for the common ownership test in the aggregation requirements will be under §267(b) or §707 (which includes family attribution from siblings and attribution from trusts having the same grantors and attribution between a trust and beneficiaries of the trust);

(5) A "relevant passthrough entity" (RPE) can elect to aggregate separate trades or businesses that are operated directly or through lower-tier RPEs (which election shall be binding on the RPE's owners but which election, if made, will eliminate the complexity of how individual owners determine if separate businesses have 50% common ownership with attribution and satisfy the other aggregation requirements);

(6) If a business has "specified service trade or business" (SSTB) activities and if the SSTB activities do not satisfy the de minimis rule (i.e., if the SSTB activities are not less than 10% of the gross receipts if gross receipts are $25 million or less and are not less than 5% of the gross receipts if gross receipts are in excess of $25 million), the entire business is treated as an SSTB rather than treating only a pro rata part of the business as an SSTB;

(7) The "anti-cracking and packing" rule is revised to eliminate the 80% test (i.e., that the business provides 80% or more of its goods or services to a commonly owned SSTB); instead, if a business provides property or services to a 50% or more commonly-owned SSTB, the portion of the business providing property or services to the SSTB will be treated as a separate SSTB with respect to related parties;

(8) The "incidental to an SSTB" rule is eliminated, meaning that a business (that would not otherwise be an SSTB) that is 50% or more commonly owned with an SSTB does not have to worry that it will become an SSTB if it shares expenses with the SSTB and has gross receipts representing less than 5% of the combined gross receipts of the business and SSTB; Treasury officials have confirmed a statement in the preamble to the final regulations that the separate non-SSTB business must have a "complete and separable" [not "separate"] set of books and records;

(9) The reporting rules are relaxed by providing that *all* of an RPE's items related to §199A (including qualified business income (QBI), wages and UBIA) should not be presumed to be zero because of a failure to report one item; instead only the *unreported* item of positive QBI, wages or UBIA is presumed to be zero, and items may be reported on an amended or late return as long as the period of limitations remains open;

(10) Electing small business trusts (ESBTs) may continue to qualify for the §199A deduction (as in the proposed regulations) but the separate S and non-S portions of the ESBT are not treated as two separate trusts for purposes of applying the income threshold test;

(11) A trust's taxable income, for purposes of determining whether the trust's taxable income exceeds the threshold amount, is calculated after deducting any distribution deduction under §§651 or 661;

(12) The §199A Anti-Abuse Rule applies if a trust (even a single trust) was created with a "principal" (rather than "significant," as in the proposed regulation) purpose of avoiding or using more than one threshold amount, and the effect is that the trust will be aggregated with the grantor or other trust(s) from which it was funded for purposes of determining the threshold amount; and

(13) The multiple trust rule regulation is revised by eliminating a definition that converted principal purpose to avoid income tax into a significant non-tax (or non-income tax) purpose that could be achieved only with creation of the separate trusts and by eliminating two examples of trusts bearing on when trusts have substantially the same beneficiaries.

For a discussion of §199A, as interpreted in the final regulations, see Item 7 of the Heckerling Musings 2019 and Other Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

2. GRATs, Estate Inclusion if Grantor Dies During Trust Term, *Badgley v. United States*

In Badgley v. United, States, 121 AFTR 2d 2018-1816 (N.D. Cal. May 17, 2018), app. filed (9th Cir. June 7, 2018), the grantor of a GRAT died about three months before the end of the 15-year term of the GRAT. Planners have traditionally believed (and regulations confirm) that GRAT assets generally must be included in the grantor's gross estate if the grantor dies before the end of the GRAT term. The estate argued, however, that the annuity payments did not represent "the possession or enjoyment of, or the right to the income from, the property" within the meaning of §2036(a)(1) because the annuity could have been paid from trust principal, not income. Reg. §20.2036-1(c)(2)(i) requires a contrary result, but the estate argued that it is an unreasonable interpretation of §2036. The court held that the retained annuity interest was enough to bring the value of the GRAT into the gross estate under §2036(a)(1) and that Reg. §20.2036-1(c)(2)(i) is a reasonable interpretation of the statute.

3. Settlement of Defined Value Clause Case, *True*

Karen S. True v. Commissioner, Tax Court Docket No. 21896-16, and *H.A. True III v. Commissioner*, Tax Court Docket No. 21897-16 (petitions filed October 11, 2016) involved a gift from Mr. True to a daughter of about $34 million with a *Wandry*-like clause (with provisions for a note to be given representing any excess value of the units transferred), and Mr. True sold assets having an appraised value of $128 million (plus additional assets were sold to another trust, the value of which is not stated in the petition), also with a price adjustment provision. Because of the split gift election, any resulting gift was made one-half by each of the spouses. Thus, the total transfers were $162 million ($128 million + $34 million) plus an additional amount sold to a trust. The gifts were made in 2012 when the gift tax rate was 35%.

The IRS determined that the transfers resulted in additional gifts by the parents collectively of $94,808,104, resulting in additional combined gift taxes of 35% of that amount, or $33,182,836. That is precisely the horror show that the parents wanted to avoid by using the defined value clauses. And indeed, the clauses did work to a very large extent, because they ended up paying only an additional $4,008,642 (combined) of gift tax. The taxpayers no doubt viewed an additional current outlay of about **$4 million rather than $33 million** as a **huge victory**!!

How much of that was simply the result of valuation compromises or reductions under the defined value clauses is unknown, but making transfers of hard-to-value assets worth well over $160 million and limiting the additional gift tax outlay to just $4 million must have been viewed as an enormous win.

4. Family Limited Partnership Discount Case, *Streightoff*

Estate of Streightoff v. Commissioner, T.C. Memo. 2018-178, valued a limited partnership interest that the decedent had transferred to the decedent's revocable trust as a limited partnership interest rather than as an assignee interest as submitted by the estate.

The partnership owned publicly-traded marketable securities and fixed-income investments. The court reasoned that the transfer to the revocable trust satisfied all of the requirements under the partnership agreement for the revocable trust to be recognized as a substitute limited partner rather than merely as an assignee. The court allowed no lack of control discount (because the 88.99% interest was sufficient under the partnership agreement to remove the general partner, which would have dissolved the partnership). The court adopted the IRS expert's approach of allowing an 18% lack of marketability discount, highlighting various factors that were recognized in *Mandelbaum v. Commissioner,* T.C. Memo. 1995-255*, aff'd,* 91 F.3d 124 (3d Cir. 1996). *Estate of Streightoff v. Commissioner*, (Judge Kerrigan).

An 18% marketability discount for a situation in which the decedent had the unilateral ability to force the dissolution of the partnership and a return of the decedent's assets seems very favorable for the taxpayer. The IRS's expert, whose conclusion was adopted by the court, did observe that the amount of control provided by an 88.99% limited partnership interest favored a lower discount.

5. No Reduction of Marital Deduction for Estate Tax on Section 2036 Transfers, *Turner III*

Turner I included FLP assets in the estate under §2036. *Turner II* said that no marital deduction is available for interests that had been gifted to others during lifetime. *Turner III*, 151 T.C. No. 10 (2018), says that the estate tax on the interests that had been gifted to trusts (other than the spouse) does not reduce the marital deduction for estate assets because the estate has the right to require the transferee to pay estate taxes under §2207B.

6. GST Exemption Rulings Regarding Trust Modifications

a. **Improper Split Gift Election, PLRS 201811002-003**. Husband made a gift to a trust. Husband and wife made the split gift election, creatively (but incorrectly) allocating ¾ of the gift to the husband's return and ¼ to the wife's return. No GST exemption was allocated on either return. The accountant later made a late allocation of husband's GST exemption to 100% of the gift. The ruling held that the statute of limitations had run with respect to the original gift tax return, so the gifts were treated as made ¾ by husband and ¼ by wife. For GST purposes, however, each spouse is treated as making a gift of one-half, so husband's GST exemption was only effective as to his one-half gift. Wife obtained 9100 relief and made a late allocation as to her one-half gift.

b. **Modification Rules for Grandfathered Trusts, Judicial Construction, PLR 201814001.** The regulations provide safe harbors allowing certain trust modifications without impacting the protected status of pre-September 1985 grandfathered trusts, briefly summarized as follows:. Reg. 26.2601-1(b)(4)

(A) Trustee action-power to distribute to new trust under instrument or state law without approval of beneficiary or court;

(B) Court settlement of bona fide issue with arms' length negotiations;

(C) Judicial construction to resolve ambiguity or correct scrivener's error: bona fide issue and construction consistent with applicable state law;

(D) Other Modifications, but with significant limitations–

-The modification does not shift any beneficial interest to a lower generation (and if that cannot immediately be determined, it is deemed to shift to lower generation); and

-The modification does not extend the time of vesting beyond the period provided in the original trust.

Reg. §1.2601-1(b)(4).

A state court determined that "lineal descendants" does not include adopted persons in construing ambiguous language to best reflect the settlor's intent. PLR 201814001 held that this action satisfied the (C) exception, so the judicial action did not affect the GST exempt grandfathered status of the trust, did not result in a gift, and did not result in realization of gain or loss because no disposition of an interest in the trust occurred.

c. **Severance of Grandfathered "Pot" Trust into Separate Trusts for Descendants**. PLR 201818005 is a good reminder that a pot trust can be severed into separate trusts for the benefit of the beneficiaries as long as the division does not shift any beneficial interest to a beneficiary in a lower generation and does not extend the time for vesting of any beneficial interest in the trust beyond a period provided in the original trust. The PLR approved an initial partition of the pot trust into five separate trusts, and also approved a subsequent modification of one of those five trusts to provide that the assets would pass in trust for the beneficiary's descendants, per stirpes, upon the beneficiary's death.

d. **Application of Grandfather Trust Safe Harbors to Zero Inclusion Ratio Trusts.** Rulings involving trusts that are GST exempt by way of GST exemption allocation (rather than by being a grandfathered trust) typically contain the following (or similar) provision:

> No guidance has been issued concerning the modification of a trust that may affect the status of a trust that is exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

However, the IRS has never actually said modification of zero inclusion trust by way of exemption allocation would cause a loss of the trust's zero inclusion ratio. No authority exists for the IRS to strip a trust of validly allocated GST exemption. (For grandfathered trusts, the issue is whether it is the SAME TRUST that was created before Sept. 26, 1985. That is not an issue for zero inclusion ratio trusts.)

Informally, IRS representatives say that if the modification does not meet the grandfathered trust safe harbors, the trust will lose "some benefit," but the IRS will not tell what the result is or precisely what benefit is lost.

e. **Extending Term of Trust Permitted by Using General Powers of Appointment so the Time of Vesting Was Not Extended**. The (D) safe harbor covers the most types of modifications, but is also the most restrictive in requiring no shift of beneficial interest to a lower generation and not permitting any extension of the time of vesting. PLRs 201820007-008 involved trust that had a zero inclusion ratios by GST exemption allocations. The trusts provided that in default of exercise of a limited power of appointment, the assets would pass to trusts for descendants until they reached age 21. The trusts were decanted into another trust providing that in default of exercise of the power of appointment, the assets would remain in trusts for the lifetimes of the descendants, but that gave each such descendant a testamentary general power of appointment. The general power of appointment was the functional equivalent of granting outright ownership, so this modification did not divert beneficial interests to younger generations and did not extend the time for vesting.

Similarly, PLR 201814005 approved modification of a zero inclusion ratio trust to remove a provision terminating the trust at age 30, but giving the beneficiary a testamentary general power of appointment after age 30, and changing the contingent distribution for one beneficiary into a special needs trust with remaining assets in that trust at the beneficiary's death passing to a foundation. Although these changes extended the term of the trust, the ruling held that the changes met the (D) exception.

7. State Income Taxation of Trusts, *Kaestner*

In *Kaestner,* North Carolina Supreme Court found that basing taxation on the beneficiary's residence in North Carolina on the facts of this case violated the "minimum contacts" component of the federal and state Due Process clauses. The North Carolina Supreme Court concluded that only the contacts and actions of the trustee or the location of the assets matter for determining nexus. The U.S. Supreme Court accepted certiorari in *Kaestner*. Various organizations, including ACTEC, have filed amicus briefs. A transcript of the oral argument on April 16, 2019 is available on the Supreme Court's website:

https://www.supremecourt.gov/oral_arguments/argument_transcripts/2018/18-457_21o3.pdf

For further discussion of *Kaestne*r (as well as the possible significance of the *Wayfair* Supreme Court case overruling of the physical presence test as to the Commerce Clause that had been announced in Quill decades ago), see Item 8 of the Heckerling Musings 2019 and Other Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

The Minnesota Supreme Court held in *Fielding* that Minnesota's taxation of the undistributed income of a trust that had no connection to Minnesota other than the fact that the trust settlor lived in Minnesota when the trust became irrevocable was unconstitutional, violating the Due Process Clauses of the Minnesota and U.S. Constitutions. The Minnesota taxing authorities also requested certiorari in *Fielding*, but no decision by the U.S. Supreme Court regarding that application has been announced.

Residents of states that do not have an income tax can nevertheless be impacted by other states' income taxation of trusts. As Mickey Davis puts it: "That Texas trust, with the Indiana farm, that has a beneficiary living in North Carolina, and a trustee living in California does not have to worry about state income tax on the trust – except in Indiana, North Carolina, and California."

8. State Estate Tax Planning Issues; QTIP Trusts for State Estate Tax Purposes

a. **Multi-State Problems**. Thirteen states have state estate taxes, and seven of them allow state-only QTIP elections. This creates significant issues for clients who own property in multiple states, or for a surviving spouse who moves after a QTIP trust has been created for his or her benefit. Recognition of QTIP trusts by states for state estate tax purposes also creates problems for states, for example if the surviving spouse no longer lives in the state at his or her subsequent death.

b. **Inbound QTIP; *Taylor* (Maryland)**. In *Comptroller of the Treasury v. Taylor*, 189 A.3d 799 (Md. Ct. Special App. 2018), the surviving wife moved from Michigan to Maryland after husband's death. The husband died in Michigan in 1989, (before the federal state death tax credit was changed to a deduction). The Maryland court ruled that Maryland could not tax the trust at wife's death because no Maryland QTIP election had been made for that trust, and the Maryland taxing statute provides that a Maryland QTIP election is required before property will be included in the estate for Maryland state estate tax purposes.

c. ***Seiden* (New York)**. In *In re Estate of Seiden* (N.Y. County Surr. Ct.) the husband died in 2010 in New York when there was no federal estate tax so no federal return was filed making a QTIP election. New York merely "piggybacks" on the federal estate tax system. The marital trust was not included in the federal gross estate because no federal QTIP election was made, so it was not included in her New York gross estate either. A proposed legislative change in the 2019-2020 New York Executive Budget would require that QTIP property be included in the surviving spouse's New York gross estate if New York previously allowed a marital deduction. The proposal would apply to estates of decedents who die on or after April 1, 2019.

d. ***Brooks* (Connecticut)**. A year earlier, *Estate of Brooks* held that Connecticut could tax a QTIP trust that was originally set up in Florida, on the theory that Connecticut just follows the federal rules of inclusion in the gross estate. The court reasoned that a sufficient shifting of wealth at the surviving spouse's death occurs to justify imposing the Connecticut tax (but that reasoning would also seem to allow Connecticut to tax the credit shelter trust, especially if the surviving spouse had a mandatory income interest.

9. State Fiduciary Cases Regarding Investments

a. **Trustee Surcharged for Diversifying Trust That Required Retaining Assets, *Post***. *In re Trust of Ray D. Post*, 2018 N.J. Super Unpub. LEXIS 1932 (2018) addressed a case that directed the trustee to retain AT&T and Exxon stock. Outside counsel advised the trustee that it could seek beneficiary consent or court approval to diversify, but it diversified without doing either. The court surcharged the trustee.

b. **Trustee Not Surcharged Despite Not Diversifying, *Wellington***. *Matter of Wellington*, 2018 N.Y. App. Div. LEXIS 6675 (2018). The bank trustee was not surcharged for failing to diversify the trust investments where the co-trustee refused to consent to diversification and had the power to remove the bank trustee.

10. Baseless Breach of Fiduciary Duty Claims

a. ***Kliman***. *Kliman v. Mutual Wealth Management Group* is an unpublished 2018 Indiana case making clear that one cannot sue a trustee:

- for denying discretionary distributions that were never requested;
- to reimburse for expenses that were not incurred;
- for denying distributions that were actually paid;
- for failing to make distributions that are required after the stepmother dies while the stepmother is still alive; and
- for failing to pay for CPR training the beneficiary did not sign up to receive.

Dana Fitzsimons adds that the court of appeals added this gem to the esteemed common law of trusts (quoting the court of appeals): "You cannot make initial distribution requests by suing the trustee."

b. ***Weitzel***. *In re Weitzel Trusts*, a 2018 unpublished Minnesota case, expounds on the basics. Dana Fitzsimons summarizes: "The Indiana Court of Appeals held that (1) a trustee does not commit a RICO racketeering violation by administering a trust according to its terms, (2) a grantor's power to exclude a beneficiary from a Crummey withdrawal right does not invalidate a trust, (3) a trustee's duties do not include making sure that your parents are not mean to you, and (4) a trustee does not have a duty to compel the grantors to make additional gifts to the trust."

11. Failed Attempt to Modify Trust to Turn Off Grantor Trust Status, *Millstein*

After tiring of paying $6 million annually for income taxes on the grantor trust's income, the grantor filed a petition to modify the trusts, to eliminate the defect that caused grantor trust status. Both the trustee and the beneficiaries, however, objected. The authority under the Ohio statute to modify trusts for tax related reasons did not apply. Furthermore, the court concluded that the grantor had no standing, because only a trustee or beneficiary may seek a modification. The court was unsympathetic because "appellant voluntarily created the situation that he now claims is inequitable." *Millstein v. Millstein*, 2018 WL 3005347 (Ohio Ct. App.), and 2018 WL 1567801 (Ohio Ct. App.).

This case highlights the importance of drafting grantor trusts to leave the flexibility of the grantor to turn off the grantor trust status of the trust.

12. Alaska's Exclusive Jurisdiction Statute Unconstitutional, *Toni I Trust v. Wacker*

The facts of *Toni I Trust v. Wacker*, 413 P.3d 1199 (Alaska 2018) considered the validity of an Alaska statute providing that Alaska courts have exclusive jurisdiction over any action based on any transfer of property located anywhere to an Alaska self-settled spendthrift trust. In a 5-0 decision of the Alaska Supreme Court, the court observed that an Alaska court can bar an Alaska creditor from bringing an action under Alaska law against an Alaska debtor for assets located in Alaska that are in an Alaska trust. But an Alaska court cannot bar a Montana creditor from bringing a claim under Montana law against a Montana debtor over property located in Montana, just because the property had been assigned to an Alaska trust. The court held that the exclusive jurisdiction provision in the Alaska DAPT statute is unconstitutional.

The court did not address choice-of-law issues or full faith and credit issues. These are the major issues that arise in determining whether a judgment rendered against a debtor in a non-DAPT statute can be enforced against the self-settled trust in the DAPT state.

13. The Dumbest Thief in Fiduciary Litigation, *Field*

In re Estate of Field is a 2018 Kansas case involving a forgery of a codicil. This is a failed attempt of a part-time bookkeeper to probate a forged will of Earl Field, which changed 30 years of prior wills that were professionally drafted by Earl's counsel that left a $20 million estate to a college.

The bookkeeper's original forged letters (that left half the estate to her) did not have witness signatures. After death when a lawyer pointed that out, she forged a new codicil that had witness signatures. She shredded the first forgeries but left the shredded forgeries in the shredder where they were recovered and reassembled. She claimed to be surprised by the codicil, while at the same time claiming that the codicil was dictated to her by Earl, but Earl never gave dictation in his entire life. He used the other typewriter. Witnesses to the codicil died by a murder-suicide after the house was searched by the FBI and they were served with grand jury subpoenas in the case. The bookkeeper traced Earl's signature exactly from his 2010 will, which is impossible forensically for anybody to sign exactly the same way twice, let alone a 90-year-old man who went into hospice five days later. She crossed the "F" in the wrong direction, from left to right when Earl would always go from right to left. She failed to use Earl's punctuation, formatting and writing style. She left a handwritten draft in the shredder that was written in her own handwriting, and she had been fired from her bank job for writing forged checks from a client account.

Items 14 - 26 are observations from the Annual Trachtman Lecture by Professor Mary F. Radford, What If Granny Wants to Gamble? Balancing Autonomy and Vulnerability in the Golden Years

14. "Warning" by Jenny Joseph

The poem "Warning" by English poet Jenny Joseph speaks to each of us about growing older. The poem begins *"When I am an old woman I shall wear purple, With a red hat which doesn't go, and doesn't suit me."* The second line of the poem became the inspiration for the founding of the Red Hat Society, a self-described playgroup for women where there is "Fun and Friendship After 50." It humorously illustrates what may be a fine line between fun-spirited eccentricity as opposed to perceived incompetency as we age. Imagine what family members will think of the older woman who, as described in the poem, spends her pension on brandy and summer gloves and satin sandals, who sits down on the pavement when tired, who picks flowers in other people's gardens, and who revels in learning to spit.

15. Population Statistics – Many More Older Women than Men; More Women Live Alone

United States gender population statistics show that for every 100 females, there are only 88 males ages 65-74, 76 males ages 75-84, and only 53 males ages 85 and older.

For noninstitutionalized adults age 65 and older, only 20% of men live alone but 35% of women live alone. By age 75, 46% of women live alone. Some may do strange things to make up for loneliness.

16. Huguette Clark – Example of Eccentricity vs. Incompetency

Huguette Clark was an American heiress and philanthropist. At age 85, she had numerous basal cell cancerous lesions removed from her face and had reconstructive surgery. She recovered and doctors "strongly urged that she go home," but she remained a resident of the hospital for the rest of her life– almost 2 decades–as a recluse. She became very close with her private nurse, and she gifted $31 million to her and her family. Five years before her death, a neurologist noted that she was "alert and cheerful, neurologically normal in every way… She seemed cute is pie, perfectly content." She had a net worth of over $300 million and gave large gifts to both friends and strangers. About six months before her death, the court turned down a request from a grand half nephew and two grand half nieces to appoint an independent guardian for her.

She died in 2011 with a will that left about $30 million to the longtime nurse, about $12 million to a goddaughter, smaller sums totaling $2 million to other employees, $500,000 each to her attorney and accountant, and the bulk of her estate to foundations that included her attorney and accountant as managers. An earlier will was signed six weeks before the second will and the earlier well left her estate entirely to her family. Nineteen of her distant relatives, none of whom had seen her for at least 54 years and many of whom had never met her, contested the will citing her "obsession with high-end, lifelike French and Japanese dolls, model castles, the Smurfs, her reclusive nurse and tendency to give her money freely as evidence of mental illness." They also accused the longtime nurse, her attorney and accountant of defrauding her. The will contest was settled within minutes before the jury returned. Under the settlement, the nurse receive none of the $30 million bequest and had to return $5 million of the earlier $31 million in gifts. The majority of the distant relatives received a total sum of $34.5 million. The rest of the estate went to foundations, but the attorney and accountant were not included as managers.

17. The Other Side of the Coin – Protecting Against Manipulation and Abuse

Brooke Astor died at age 105 as a wealthy philanthropist. Her 80--year-old son was convicted of looting her estate.

Sarah Cochran was a grandmother who loved to gamble. Between ages 75 and 79, she spent about $700,000 on scams. At her guardianship hearing, she testified with acuity about her assets, but upon telling the judge that she needed to leave the hearing to meet a man from Jamaica with another scheme, the judge appointed a conservator. The court of appeals agreed with the probate court that a conservator should be appointed, but the court observed that the mere fact Mrs. Cochran chose to play these fantasy games does not in and of itself mean she needs a conservator. It noted that a person of perfectly sound mind, capable of understanding that the lotteries might be a fraud, nevertheless might choose to play the lotteries as "escapist fantasy and fun."

18. Balancing Protection with Danger of Overprotection

In effect, the court in the Sarah Cochran case was balancing eccentricity with financial incompetency, ending on the side that she needed a conservator. How do we protect the freedom of women who might be of sound mind while at the same time protecting those with dementia against elder abuse? That society is paying attention to elder abuse is laudable, but we should always be aware of the warning that we may be in the process of overprotecting our elder society.

19. Perfect Storm of Factors Increasing Vulnerabilities of Elders, Especially Aging Women

Wealthy older Americans are living longer than ever, handling their own retirement benefits, with less financial capacity, with a belief that they have retained their financial capacity, and are more trusting of people around them.

Furthermore, the degree of cognitive decline is increasing. About 5.8 million Americans have symptoms of Alzheimer's, and of those about 5.5 million are age 65 or older. The number of Americans with Alzheimer's is expected to increase to 14 million by 2030. Aside from Alzheimer's, studies show that all people experience some age-related decline in the specific neural systems that allow us to make complex decisions.

These risks are especially important for women. While women live five years longer than the average male, the consequences of the longer life can be dire. One study concludes that the average woman will have 194% higher healthcare costs than the average man.

In addition, older women are more likely to be alone than men. Every year, 800,000 people become widows or widowers, but 700,000 of those are women. The divorce rate for couples over age 50 has doubled, and over age 65 has tripled, and substantially more men remarry than women.

Furthermore, many baby boomer women have chosen to have fewer children or no children. Between 1970 and 2010, the number of women who were childless at the end of their child bearing years doubled. In addition, parents are now outliving their children due to a number of factors, so parents who used to depend on their children are living beyond them.

These facts have combined to create an increasingly large group of "elder orphans" or "unbefriended adults." Estimates are that about 25% of Americans risk being elder orphans, and more of them are women than men.

A 2009 report concluded that two-thirds of reports of elder financial abuse to adult protective services are regarding women. This is not surprising because people with dementia are at greater risk of elder financial abuse and two-third of people with Alzheimer's are women.

"We have women of means, alone, isolated, vulnerable due to cognitive loss, trusting by nature versus the vast array of predators and scammers who are out there in our society."

20. Elder Financial Abuse

a. **Description**. While there is no legal or societal definition of elder financial abuse, it generally is very simply described as another individual using an elder's money for his or her own interest without the elder's consent.

b. **Widespread**. Examples of elder abuse abound. In 2017, 50,000 people ages 60 and up lost $342.5 million due to Internet fraud. Studies show that elder individuals lose between $2.9 million up to $36.48 billion every year due to elder financial abuse. That is only the tip of the iceberg, because other research indicates that only one in 14 cases of elder abuse is reported.

c. **Examples of Types of Abuses**. One example of elder abuse is the "Grandparents Game." Grandchildren have exposed their entire lives on social media. A third-party predator contacts the grandparent, pretending to be a lawyer or law enforcement officer, saying that the grandchild needs money immediately (and they are now typically demanding gift cards instead of cash).

   A second example is the "Sweetheart Scam." This begins with an online dating service, and the target is groomed over time, leading to more intimate interactions, sometimes even marriage. A catastrophe occurs in the new lover's life, and money is needed. Losses have ranged up to $500,000-$2 million in these cases. The victim ends up heartbroken and shamed as well as financially devastated.

d. **Who Are Victims**? One group of likely victims is people who are cognitively impaired, overly trusting, dependent on others, socially isolated, and lonely. Another group of victims are known as "high achievers." These are good targets if they are cognitively impaired because of their higher wealth. Furthermore, the scam will be less apparent to those around them because the victims have "reserved capacity," an ability to mimic capacity in a way that masks their own cognitive impairment. The high achievers are proud people who do not want to admit something is wrong and will not reach out to others for help.

e. **Who Are Perpetrators**? Some perpetrators of elder abuse are third-party scammers but perpetrators also include trusted advisors such as attorneys, accountants, financial advisors, caregivers, and family members. A 2001 report said that 34% of elder abuse came from family friends, neighbors, or caretakers. A later study showed that 60% are family members, 16.9% are friends or neighbors, and 14.9% are caregivers.

f. **Closer Relationships Less Likely to be Reported**. The closer the relationship between the perpetrator and victim, the less likely elder abuse is to be reported. Factors include embarrassment, uncertainty that abuse has actually occurred (was the son's convincing mother to buy him a new house or car financial abuse?), fear of being abandoned, guilt over whether children actually deserved the money, reluctance to air family dirty laundry, and aversion to sending a family member to jail.

g. **Cure May be Worse than the Harm**. Most important, victims understand that the cure for abuse may be worse than the harm. Victims have the **very realistic fear** that when they reveal their own vulnerability and their own victimization to their family, family members will institutionalize them or adult protective services will **take away their freedom**. What other crime in our society carries such a **tremendous risk to the victim of losing her own freedom** by reporting the abuse?

21. Laws Protecting Against Elder Abuse

a. **Federal Laws**. Federal laws against elder abuse include the Senior Safe Act enacted in 2018 and the Elder Abuse Prevention Act enacted in 2017.

b. **State Laws**. In addition, the states have all responded with elder abuse laws. Almost all states have mandatory reporter statutes, requiring individuals to report suspected elder abuse to adult protective services. Some states have criminal statutes criminalizing activity involving elder individuals that would not otherwise be a crime (such as undue influence). Some states enhance the penalties if certain crimes (such as fraud) are perpetuated against older individuals.

c. **Risk of Stereotyping All Elders**. These efforts are laudable, but they have hit subtle and hidden concerns. The statutes run the risk of stereotyping all elders as weak, fragile, confused, and vulnerable, sometimes having the unintended consequence of robbing freedoms from someone who does not need to be protected.

d. **Back to Balancing Against Elder Financial Abuse While Protecting Autonomy.** "How do we protect our grandmothers and our grandfathers from the predation that's out there while at the same time protecting and safeguarding their autonomy? In other words, if Granny really has solid sound cognitive abilities and she has the resources and can afford to do it, why shouldn't we let her gamble?"

22. Why Autonomy Is So Valuable

Autonomy is the freedom to pursue one's own life choices without forced intervention by anyone else, including government or family. The autonomy of an elder individual can be taken away by private or public mechanisms. The family can privately bring a petition for guardianship or to institutionalize the individual. The government can issue an elder abuse report, Adult Protective Services can put into place a plan for protecting the individual, and law enforcement may get brought in to pursue criminal liability. If Granny is institutionalized, she may not be able to decide basic life decisions such as what to eat, when to eat, or even to lock her door.

If a guardianship is instituted, the individual loses the ability to decide if she will marry, consent to medical treatment, or where she will live. If a conservator (guardian of the property) is ordered, she loses the ability to handle her tangible or intangible property. She cannot buy clothes she wants, take trips, or play games that she wants to play.

23. Recommendations for Law Changes

a. **Typical Existing Laws**. Most states list mandatory reporters of elder financial or physical abuse. The laws typically apply to individuals age 65 or older, and many of them focus not on vulnerability but just on age. In effect, they infantilize older adults, and the price some elders may pay is state intervention. For example, if a person marries at age 64, lends money to her son, or buys a present for boyfriend, all is fine, but if the individual waits to do those things until age 65, then a doctor, psychiatrist, counselor at a church, or maybe even a lawyer may be *required* to report the activity if that adviser suspects elder abuse. Individuals at age 65 may stop seeking professional advice or assistance if they know that a mandatory elder abuse report may be the result.

b. **Change Age-Based Statutes**. Some existing statutes just refer to "vulnerable adults," and they seem to be efficient. This seems preferable to an arbitrary age listing.

c. **Remove Defense From Criminal Statutes Based on Inability to Determine Age**. Criminal statutes that enhance penalties if the victim is 65 years of age or older, typically provide an affirmative defense if the accused could not have known or determine the age of the victim. The statutes should be revised to remove the immunization from liability based on an inability to determine the victim's age. For example, the Internet scammer should not be protected because the scammer has no way of knowing that the victim is age 65 or older.

d. **Focus on Mediation, Facilitators**. A huge problem is that victims will not report family members for elder abuse. An effective alternative is mediation or for a neutral facilitator to work with the family. Once the problem is surfaced, it usually ends. A nuanced approach to a nuanced problem is required.

e. **Reforming of State Guardianship Laws**. The modernized Uniform Guardianship, Conservatorship, and Other Protective Arrangements Act emphasizes involving individuals in making decisions about their own lives. Article 5 of the Uniform Act encourages the court to favor tailored solutions matching particular needs of a ward rather than ordering full-fledged guardianships.

24. Recommendations for Lawyers

a. **Education**. Lawyers should educate themselves and every client about elder abuse issues.

b. **Legal Instruments**. Much of the elder financial abuse occurs through the use of vehicles prepared by lawyers, such as powers of attorney, deeds for joint ownership of property, trusts, etc. Lawyer should not write a document for someone who is not present to talk with the lawyer.

c. **Dealing with Diminished Capacity Clients**. Lawyers should ramp up their understanding of signs of clients starting to show diminished capacity. For those clients, lawyers should put into place protective mechanisms, going beyond just creating trusts and powers of attorney, but including things such as trust protectors and family oversight committees, always keeping in mind that the person to whom we are giving power may end up abusing that power.

   Lawyers should demand more clarity from bar associations of how to deal with clients with diminished capacity. Rule 1.14 of the Model Rules of Professional Conduct addresses clients with diminished capacity, but ignores the areas of vulnerability and susceptibility. A client can have a high level of capacity, but still be susceptible to risks.

d. **Reporting Elder Abuse**. Attorneys should demand that legislatures and bar associations clarify the responsibilities of lawyers for reporting elder abuse. In some states, lawyers are mandatory reporters. That is contrary to the attorney-client confidentiality that is the hallmark of the attorney-client relationship.

   On the other hand, lawyers need to have the discretion to report abuse without fearing professional discipline. Illinois says that anyone can report suspected elder abuse, and if in good faith with the best interest of the victim in mind, the reporter is immunized from disciplinary action, even if the information was otherwise confidential. Georgia's professional conduct rules allows a lawyer to reveal confidential information if necessary to avoid or prevent substantial financial harm that would result from third party criminal conduct.

e. **Ask for Trusted Contacts**. Attorneys should discuss with clients the potential for future elder abuse, and ask the client if he or she is willing to provide names of someone who could be contacted if the attorney suspects elder financial abuse.

25. Recommendations for All of Us to Help Balance Autonomy and Elder Financial Abuse

a. **Fighting Elder Abuse**. For our own benefit as well as helping vulnerable adults that we know, we should be sensitive to the huge concerns of elder financial abuse and scams being employed. Scams include callers saying that new Medicare cards cannot be sent without providing the person's Social Security number, changing caller ID on phone so that the scammer's call appears to be from a bank or charity, free trial offers (for example for over-the-counter drugs or supplements) that end up with long binding contracts, hacking personal computers and scaring people into giving away information, and email bombardment of scammed offers.

   Give simple advice to persons susceptible of elder financial abuse, such as never give out personal information over the phone, never allow anyone on your computer, install malware, or just hang up.

   For a modest fee, a professional service (rather than the drug-addicted son) can handle bill pay or provide a ride sharing service.

   Some companies offer prepaid credit cards that disable certain kinds of transactions (but still give a modicum of financial freedom).

   Realize that people who live alone are more likely to be targeted, so just staying in touch with vulnerable individuals may be enough.

b. **Protecting Autonomy**. Overprotection revolves around the fact that almost every discussion of elder financial abuse assumes that elders are all the same. The flipside is true as well; if one in 10 people have Alzheimer's, nine in ten don't.

   Eliminate stereotyping to get rid of certain pejorative terms. Excise from our vocabulary certain terms, such as old maid, dotty, old hag, blue-haired little old lady, old codger, and over the hill.

   These can have bad effects on older people, and can cause them to start making less wise decisions.

   One study subjected people age 65 and older to positive subliminal messages about aging stereotypes over a 4-week period. Not surprisingly, they had greater self-esteem and decreased levels of anxiety about aging, but what was most impressive is that these individuals showed more positive health results than another group that had been engaged in an exercise program for six months. Studies show that positive attitudes toward aging quicken recovery from severe disability, shorten hospital stays, and increase longevity.

Three age-based generalizations are not always true and create false impressions. We should understand nuances around these generalizations.

(1) Older people, especially women, are depressed and unhappy. (That is why scammers bombard older women.)

(2) Older people, especially women, lack the ability to make sound decisions. While some decline in financial capacity occurs, some studies show that for the average individual age 65 or older, strategic learning capacity and the conscientiousness of decisions *increases* with age; physical changes enable the aging brain to become better at detecting relationships between diverse sources of information, capturing the big picture and understanding the global implications of specific issues. Robert Frost expressed the same view, but more eloquently: "I think young people have insight. They have a flash here, a flash there. It's like stars coming out of the sky in the early evening. However, it is later in the dark of life that you see forms and constellations." While studies show that the aging brain shrinks over time, on average, the female brain shrinkage is three years younger in terms of that shrinkage than the male brain.

(3) Older people are less creative and less able to learn new things ("old dogs can't learn new tricks"). This generalization is dangerous because it has internal and external consequences. Older people internalize that they can't learn, so they don't try. "I'm too old to do that." The external connection is more complex. Many influential industries advertise for young progressive creative workers. In advertising agencies, 60% of the employees are age 25-44 and only 5% are over age 50. Younger hip workers in the ad agencies saturate the media with the stereotypes about age including that youth equals beauty. This gives fraudsters a very powerful tool for selling their most notorious product, the anti-aging product. Most of these are fraudulent and contain harmful chemicals. We've all seen the "I've fallen and I can't get up" ad.

Studies show that the generalization is not true and older people are not less creative. Many examples exist of the creativity of older people. For example, Ben Franklin created the bifocal at age 78. Studies of the brain have shown that the aging brain in some ways closely resembles the creative brain. Fearlessness and lack of inhibition is associated with creativity. Older people are more distractible with less cognitive control (for example, to "stay on task"), but cognitive disinhibition aids creativity, increasing the ability to look at all of the information around us and enhancing our ability to detect patterns, and to approach problems in a novel manner, and to reach solutions by relying on broad associations performed from diverse bits of information. The research concludes that reduced cognitive control in older adults may boost creativity and the ability to solve problems with insight.

26. Summary–Face the Reality of Elder Abuse and Be Especially Vigilant in Guarding Autonomy

Professor Radford concludes:

> We definitely do need to face head on the reality of elder financial abuse. But we need to frame the threat not as to the elders themselves but as to those who are vulnerable, not to those who have reached a certain age.

> We need to protect the many older women who are alone, but part of that protection must be guarding the autonomy of our aging population. We might and often need to remind ourselves that for many women, aging isn't a descent into madness, but rather it's a loosening of the restraints of middle age, and a loosening of the filters that permeated their lives when they were young. And the fact that the filters have worn down doesn't necessarily mean that the individual needs to be protected from herself.
>
> So in short, sometimes older women simply want to spend their pensions on brandy, lots of it. They want to eat sausages by the pound, instead of seven servings of fruits and vegetables a day. They want to wear terrible shirts and grow fat instead of wearing age-appropriate clothing and counting their calories. And sometimes, we older women simply want to wear purple with a red hat that doesn't match.

Items 27-33 are observations from a symposium by Jeff Glickman (J4 Capital LLC, Seattle, Washington), Michael L. Graham, and James D. Lamm, "I'm Sorry Dave. I'm Afraid I Can't Do That." – The Impact of Artificial Intelligence on Estate Planning and Administration

27. Ethical Rules Impacted by Technology

a. **Technology Issues**. Recent technology issues that may raise ethical concerns include cyber threats to confidential client information – phishing and ransomware. Other recent technology issues for estate planners include planning for digital property, legislative developments regarding electronic wills, and artificial intelligence issues.

b. **Model Rule 1.1, Competence**. "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." A new addition to comment 8 provides that lawyers should "keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology…."

c. **Model Rule 1.6, Confidentiality of Information**. "(c) A lawyer shall make reasonable efforts to prevent the inadvertent or unknown unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client."

   Comment 18 requires lawyers to act competently to safeguard information. Furthermore, comment 18 provides that a client may require the lawyer to implement special security measures not required by Rule 1.6(c) or may give informed consent to forego security measures that would otherwise be required.

   Comment 18 clarifies that "reasonable efforts" factors include sensitivity of the information, likelihood of disclosure if additional safeguards are not employed, cost of employing additional safeguards, difficulty of implementing the safeguards, and extent to which safeguards adversely affect the lawyer's ability to represent clients (for example because of their difficulty of use).

d. **ABA Opinions**. ABA Formal Opinion 11-459 states that a lawyer communicating with the client by email "ordinarily must warn the client about the risk of sending or receiving electronic communications … where there is a significant risk that a third party may gain access."

   ABA Formal Opinion 477R addresses the requirement that a lawyer use reasonable efforts to prevent inadvertent or unauthorized access. It states that using unencrypted routine email generally constitutes an acceptable method of communication, but is not always reasonable. It includes guidelines about reasonable efforts that should be taken with respect to technology and information security issues.

ABA Formal Opinion 480 addresses confidentiality obligations for lawyer blogging and other public commentary.

ABA Formal Opinion 483 discusses lawyers' obligations after an electronic data breach or cyberattack.

The general approach of the ABA opinions is that security should be balanced with practicality.

e. **Engagement Letters**. ABA Formal Opinions 11-459 and 477R both recommend informing clients about certain risks involved in electronic communications. Lawyers should consider including such a provision in engagement letters. Jim Lamm provides the following suggested clause:

> In the process of representing you, we may send to you or receive from you substantive communications by electronic means. Please be aware that, in certain circumstances, there could be a significant risk that a third party may gain access to unencrypted email or other electronic means of communications, including if you use a business-provided device or email address, if you use a personal device or email address to which others have access, if you use a public device, such as a library or hotel computer, or if you use a borrowed device. By engaging us to represent you, you are consenting to us sending you substantive communications by unencrypted email or other electronic means of communications. If at any time you do not want us to send substantive communications to you at a particular email address or if at any time you want us to use encryption or implement any other special security measure in sending you substantive communications by electronic means, please notify us in writing. If you have any questions about electronic communications with us, please contact us.

28. Four Planning Steps for Dealing with Digital Property

Important planning steps for dealing with digital property include:

(1) Prepare a list of digital property, how to access it (list passwords and let someone know where the list is maintained), and what to do with it;

(2) Back up important data;

(3) Protect valuable data with a strong password and strong encryption; and

(4) Update estate planning documents with provisions giving lawful consent to disclose the contents of electronic communications to fiduciaries.

29. Artificial Intelligence – General Description and Concepts

a. **Artificial Intelligence (AI)**. AI is the ability of machines to mimic human processes, including any computational method that attempts to re-create intelligence using computers.

Narrow AI is capable of performing a single task, using as a resource a single data set. For example, a computer that is programmed to beat the world's best chess players would be an example of narrow AI.

General AI is capable of exhibiting human intelligence and of performing tasks more or less like a human would. This is a general goal of artificial intelligence, but beyond current technological capability.

b. **Artificial Super Intelligence (ASI).** ASI is the ability to exhibit intellect much smarter than the best human brains in practically every field (scientific creativity, general wisdom and social skills). ASI is the pathway to general AI. For AI machines, the program code remains static; the machine does what the programmer tells it to do. In ASI, the machine decides what to do, how to write its own code, what it should consider and what to reject in accomplishing the tasks at hand. With ASI the machine programs itself.

J4 Capital LLC has a super computer that is at the ASI level, and to date has been involved in the financial markets. The machine is turned off each night, and starts afresh each new day, for fear of what the machine might do if left to learn day after day from the prior days of learning. Jeff Glickman says that the difficulty is not in enabling an ASI machine to make decisions on its own (that is now being done each day on the J4 Capital super computer), but in giving the machine a moral code as the framework for how it accomplishes the goals it is given.

Jeff Glickman is now beginning a project on General AI with the J4 Capital super computer.

30. Societal Impact of Artificial Intelligence

AI will impact our personal lives more quickly than our business lives, but it will have a job displacement impact.

Boston Consulting predicts that 25% of all jobs will disappear by 2025. The University of Oxford predicts that 40% of all jobs will be lost by 2033. In the past, jobs that were lost due to technological advances have been replaced by jobs in the technology sector. However, the rate of increase in technology jobs is starting to peak, and the rate of net job displacement is increasing.

Artificial super intelligence is even more capable and will be vastly more disruptive on job displacement. As an example, the J4 Capital super computer company has three technicians; the rest is done by computers. The effect of massive unemployment due to ASI means that we must rethink the structure of society. (For example, will some type of "universal income" system be needed? Three hundred million people are on that kind of system in India currently.)

31. Legal Support Available in Today's Technology

Various types of legal support exist already. Examples of these support models include the following.

a. **Administrative Support**.

Calendars, case management, and document management (Lexis-Nexis, Juralaw, Mycase, Airdesklegal)

Dictation (Nuance, Voiceautomated)

Translation (Viadelivers)

b. **Litigation Support**.

e-Discovery (LexisNexis, KPMG, IProTech)

c. **Lawbots (Self-Help AIs)**.

Founding Documents

– Incorporation (RocketLawyer)

– Bylaws, Actions (Wilmerhale)

Intellectual Property

– Confidentiality documents (Docracy)

– Patent search (Google Patents)

– Copyrights (TrademarkEngine)

– Trademarks (TrademarkNow)

– Patents (LegalZoom)

Compliance

– Taxes (TurboTax)

– Visas (Visabot)

– DMCA (LegalRogot)

Agreements

– Contracts (Docracy)

– Privacy (FreePrivacyPolicy)

– Trusts (InteractiveLegal)

d. **Document Search, Legal Research**.

– (RossIntelligence)

e. **Document Understanding**.

Contract analysis (LegalRobot, eBrevia, Beagle)

Read, interpret, and extract document content (iManage)

Temporal document analysis (NextLP)

f. **Legal Strategy**.

Predict case outcomes (CaseCrunch)

Predict winning combinations of cases, lawyers and judges (Premonition)

32. Artificial Intelligence Impact on the Law

AI will erode from the bottom, from the least skilled to the most skilled, which is an extension of what has already occurred with technology advances. AI will replace (in order) administrative support, litigation support, paralegals, and associates. Eventually, AI could lead to a complete case assistant, integrating all functions except human interactions (meetings, depositions, courtroom work, etc.).

An interesting example is the recent Google demonstration of a virtual assistant making an appointment on a phone call. It seems clear that the person who called to make the appointment does not realize that he or she is talking to a machine. Interpersonal relationships and moral judgments are difficult at best even for the best of ASI. Despite the human-like advances that will be made, human interaction would seem to be at the heart of much of the traditional practice of law. Interacting with clients, and being able to empathize with the client's situation while providing answers and paths to resolution, has been at the heart of the law practice.

33. Strategies for Remaining Relevant in the Age of Machines

(1) Differentiate instead of expanding.

(2) Stay in front – always be on the cutting edge in what we do. "Today's rocket science is tomorrow's mass production."

(3) Be more efficient by adopting new technologies (realizing that sometimes lands one on the bleeding edge rather than the cutting edge).

(4) Stay current.

Items 34-38 are observations from a seminar by Suzanne Brown Walsh (moderator), Benetta P. Jenson, and Wendy L. Moore (Perkins Coie, Palo Alto, California), The Future Is Here: Dealing with Bitcoins and Cryptocurrencies in Tax and Estate Planning

34. Blockchain and Cryptocurrency General Description

a. **General Description**. Blockchain is the underlying technology of cryptocurrencies, like Bitcoin and others such as Eretheum and Litcoin. The fundamental components of blockchain technology involve the use of a distributed ledger stored on a highly encrypted, immutable ledger, which is verified by a peer-to-peer network. It works as an immutable record of transactions that do not require reliance on an external authority (such as banks or financial institutions) to validate the authenticity and integrity of the data. All blockchains are essentially distributed ledgers that record transactions on linked blocks stored on a highly encrypted immutable ledger verified by a peer-to-peer network. Transactions are typically economic, but any kind of information can be stored in the blocks.

   Blockchain technology was first applied in the financial sector in January 2009 when the first block (like a page in a ledger and referred to universally as "the genesis block") of the Bitcoin blockchain was formed. The Bitcoin blockchain has over 555,000 blocks, all linked together.

There is no single blockchain. Each of the various cryptocurrencies have their own blockchain, with varying functions and capabilities. For example, the Eretherum blockchain can execute "smart contracts" (self-executing agreements that are executed automatically without a middleman as described events occur), which is not possible in the Bitcoin blockchain.

A fundamental component of a blockchain is that the ledger or recording of transactions is kept on a distributed ledger as opposed to a central ledger. Everyone who is part of the peer-to-peer network will have an exact copy of the ledger, so each transaction is recorded on each copy of the ledger and peers check changes to the ledger.

The value of cryptocurrencies is set by the marketplace and can be volatile, even throughout each day. At its outset in 2010, each Bitcoin had a value of less than $0.05. The value of each Bitcoin peaked on January 1, 2018 at $19,498.63, and beginning in 2019 has leveled off at about $3,800 - $4,000 each.

b. **Wallets; Private Keys**. For financial transactions using cryptocurrencies, each participant has a "wallet" containing a cryptocurrency address and a private key to access the cryptocurrency.

Wallets may be stored as either "cold" or "hot." Cold storage is a wallet that is held off-line, usually on a sophisticated USB drive (an example is a Trezor Bitcoin wallet). A cold wallet is the safest storage because only the physical holder of the wallet/USB drive can access and use the cryptocurrencies stored in the cold wallet. If the drive is lost or stolen, or if the user fails to remember the passkey to access the wallet, it (and all of the cryptocurrencies that may be accessed by it) may be entirely lost. Conversely, a hot wallet is stored online, and may be susceptible to hacking or hijacking.

c. **Example of a Blockchain Transaction**. The following description of a blockchain transaction is quoted directly from the excellent materials by Austin Bramwell, Abigail Earthman, Benetta Jensen, and Suzanne Brown Walsh.

> Mark who lives in Montreal wants to send Lisa who lives in Lisbon 5 Bitcoins for graphic design work Lisa performed. Mark and Lisa are both participants on the Bitcoin blockchain and each have Bitcoin wallets on their computers. Wallets essentially are files that provide access to blockchain addresses and an address is a string of alphanumeric characters. For example, an address might look like the following:
>
> 1FcyBEKt5S2GDtv7aQw6rQepAvnsRyHoYM. Each Bitcoin blockchain address holds a balance of Bitcoins.
>
> [The following four steps occur]:
>
> 01 <u>Mark sends funds</u> - Mark sends Lisa funds to Lisa's address by broadcasting the transaction to miners [described below];
>
> 02 <u>Miners validate</u>. One or more miners validate the transaction, chaining a new block to the blockchain;
>
> 03 <u>Miners broadcast</u>. Miners aggregate, validate, and broadcast blocks to each other; and
>
> 04 <u>Lisa receives funds</u>. Every node and miner now has a record of the transaction and it cannot be altered. Lisa now has Mark's funds in her wallet.
>
> [These transactions are furthered explained as follows.]
>
>> (1) Lisa might send her address to Mark via a bar code or other digital signature form. Once Mark initiates the transaction on his computer, the four steps [described above] occur within a matter of minutes. Mark's wallet has a cryptocurrency address and a private key, which broadcasts the payment to a Bitcoin miner or miners.

(2) Miners are supercomputers or a pool of supercomputers that bundle transactions over the past 10 minutes or so into blocks. Miners perform the function of "hashing" the transaction or making the transaction secure using cryptography. Simplistically, miners "hash" a transaction by solving a complex math equation, which they are constantly doing. After a short period of time, a miner will take a series of transactions and will complete them, which creates a block. The newest block then is linked to additional blocks in a chain (the number of blocks make up the block height and the full chain is called a distributed ledger).

(3) Miners verify that Lisa and Mark both have valid Bitcoin blockchain addresses and wallets that can send and receive funds. Miners also verify that Mark has 5 Bitcoins in his Bitcoin wallet and that the coins have not been used before, avoiding the "double spend" problem.

(4) Once Mark and Lisa's transaction is on the Bitcoin blockchain, it cannot be altered. It is immutable. Any participant in the network at any time can go back and verify the transaction and copies of the transaction are shared on the distributed ledger, where every node/computer has a copy of the ledger. No central participant controls the entire ledger, making the blockchain more secure than a central database. If one tried to alter a block that contained the transaction (a hard feat itself), they then would need to go into every previous block and change that transaction as well, ensuring that all blocks had the same data, which is nearly impossible.

35. U.S. Tax Treatment

a. **Notice 2014-21**. Notice 2014-21 generally just applies "existing tax principles" to virtual currency transactions, and suggests that new rules (such as regulations issued pursuant to §7805) are necessary.

(1) **Convertible Virtual Currency**. The Notice defines "virtual currency" as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." It does not have "legal tender status in any jurisdiction." Convertible virtual currency has an equivalent in real currency or acts as a substitute for real currency. On the other hand, nonconvertible virtual currency is virtual money used in online role-playing games (such as Pokecoins in Pokemon), but cannot be converted into real currency. Notice 2014 – 21 only addresses the tax consequences of convertible virtual currency.

(2) **Treated As Property**. Virtual currency is treated as property and general tax principles applicable to property transactions apply to virtual currency transactions.

(3) **No Foreign Currency Gain or Loss**. Virtual currency cannot generate foreign currency gain or loss.

(4) **Gross Income on Receipt**. Virtual currency received in payment for goods and services must be included in gross income equal to the fair market value of the virtual currency on the date it is received.

(5) **Basis**. The basis of virtual currency received is its fair market value on the date received.

(6) **Fair Market Value of Virtual Currency**. Fair market value is determined by converting virtual currency into dollars at the exchange rate listed on a virtual currency exchange (such as Coinbase) "in a reasonable manner that is consistently applied." This description leaves uncertainty because of the volatility of virtual currency and the fact that virtual currency is valued differently on different exchanges. If wide swings in value occur on the day of the transaction, is a "reasonable manner" to use the exchange rate as of the specific time of the transaction?

(7) **Sale or Exchange**. If a taxpayer exchanges virtual currency for other property, gain or loss may result, depending on the fair market value of the property compared to the basis of the virtual currency exchanged. Whether gain or loss is ordinary or capital depends on whether the virtual currency is a capital asset.

(8) **Receipt in Return for Mining Services**. A taxpayer who "mines" virtual currency (*i.e.*, receives virtual currency in exchange for running a computer to validate transactions and maintain a public ledger) has gross income equal to the fair market value of the mined virtual currency on the date of receipt.

(9) **Employment Tax Issues**. The fair market value of virtual currency received for services as an independent contractor or for mining virtual currency (other than as an employee) is self-employment income subject to self-employment tax. Wages paid to an employee in the form of virtual currency are subject to income tax withholding, FICA and FUTA withholding, and reporting requirements.

(10) **Basis of Virtual Currency Acquired from a Decedent**. A wallet providing access to virtual currency should be considered property that is acquired or passes from the decedent qualifying for a basis adjustment under §1014(a). A wallet typically contains multiple keys, and each private key should obtain a separate basis under §1014(a) (though this is not discussed in Notice 2014-21).

b. **Wealth Transfer Tax Issues**.

(1) **Not Addressed in Notice 2014-21**. Notice 2014-21 does not explicitly address transfer tax consequences of virtual currency transactions, but in applies "existing general tax principles" to transactions involving virtual currency.

(2) **Gift Issues**. When a gift becomes complete is uncertain if a donor delivers physical possession of a wallet containing a private key, but retains a second copy of the same private key in a different wallet (or if the donor has otherwise recorded or memorized a private key) and therefore still has access and control over the virtual currency. Possible theories are (1) the gift is incomplete until the donor surrenders the second copy of the private key or otherwise no longer has access, (2) the donor has made a completed gift subject to a retained interest, or (3) the retention by the donor of a second copy of the same private key is reflected in a discounted value of the gift. What is the impact if the transferee acts to cut off the grantor's access by selling the currency or transferring it to a different wallet?

(3) **Valuation**. Because the conversion of virtual currency into dollars may be made at the exchange rate in "any reasonable manner that is consistently applied," the high/low averaging method that applies to publicly traded securities should not necessarily have to be used, although presumably it may be used.

Discounts may apply in valuing virtual currency for various reasons including security reasons (for example, if multiple copies of the wallet exist, that gives someone else possible access to the virtual currency) or because of the lack or difficulty of access to the contents of a wallet.

36. Charitable Planning

a. **Donor Advised Funds Sometime Accept Cryptocurrency**. Some large donor advised funds (such as the Fidelity Fund) accept cryptocurrency (but typically convert out of the cryptocurrency as soon as possible because of its volatility).

b. **Substantiation Requirements**. A charitable income tax deduction of more than $5,000 requires a "qualified appraisal." The appraisal requirement does not apply to a gift of publicly traded securities, but there is no exception for cryptocurrency. Because the price of cryptocurrency often is readily available from exchanges, the IRS should permit an exception to the qualified appraisal requirement for cryptocurrency whose prices are available from exchanges.

c. **Will Convert Quickly**. Charities typically convert cryptocurrency into dollars quickly.

37. Fiduciary Issues

a. **Locating Cryptocurrency**. One of the duties of a fiduciary is to marshal assets. Locating the existence of and gaining access to cryptocurrency can be difficult without proper planning. Fiduciaries have traditionally been advised to wipe any laptop before it is given to a beneficiary, but wiping a computer clean may prevent obtaining access to digital assets available only through encrypted information on the computer.

b. **Trust Funding**. Most institutional trustees and traditional asset custodians are not willing to accept cryptocurrency (a workaround is to use a directed trust and authorize a direction advisor to deal with cryptocurrency). One way to transfer virtual currency to a trustee is to send it to the trustee's online wallet account. Another way is for the grantor to transfer his or her private key to a secure physical device and transfer possession of the device to the trustee, and document the transfer. Cryptocurrency can be very volatile, so any delay in accessing cryptocurrency might result in substantial loss.

c. **UTMAs and 529 Plans.** The Uniform Transfers to Minors Act defines "custodial property" broadly, which would include virtual currency. However, 529 plan accounts generally cannot include cryptocurrency unless the State Treasurer's investment options specifically include cryptocurrency investments.

d. **Fiduciary Duties**. The Uniform Prudent Investor Act requires that investments be made in a prudent manner. Is cryptocurrency a prudent investment? The duty of diversification may be violated if the trust has a large cryptocurrency concentration. If the settlor intends that the trustee retain cryptocurrency, the trust agreement should clearly authorize its retention and exonerate the fiduciary for retaining it. A directed trust could provide a trustee with additional comfort in retaining cryptocurrency holdings.

38. Practical Considerations in Advising Clients

a. **Ask About Cryptocurrency**. The planner should ask clients about cryptocurrency and discuss access to it. Access can be made available by technology-based plans (multi-signature wallets, a smart contract triggered by death, etc.) or a non-technology-based plan relying on printed private key information that is stored off-line in a secure location.

b. **Educate**. Educate the client and client's family regarding practical aspects of disposing of crypto currency and best practices regarding private keys.

c. **Drafting**.

(1) **Dispositive Provisions**. Be very explicit with respect to the disposition of cryptocurrency. Consider adding a provision that a bequest of tangible personal property does not include cryptocurrency wallets. Austin Bramwell suggests including the following exception from what is considered tangible personal property: "cash, bullion, cryptocurrency wallets of any kind, including any cryptocurrency paper wallets, hardware wallets, desktop wallets, or mobile telephone wallets."

(2) **Access Provisions**. Most newly drafted wills and revocable trusts include a clause giving fiduciaries access to digital assets. Consider including in that provision specific authority to access cryptocurrency using the same language as described in the preceding paragraph and providing that the clause applies generally to digital accounts including cryptocurrency exchange accounts.

d. **Blockchain Wills**. Blockchain wills are not a current practical reality, but someday they may be. *See* Bridget J. Crawford, *Blockchain Wills*, INDIANA L.J. (2019).

Items 39-46 are observations from a seminar by David A. Handler, Lester Bernard Law, and Paul S. Lee, The Basis Adjustment Toolkit: Shift, Manage, and (Consistently) Report Basis

39. Basis Effects of Gifts

a. **Impact of Anticipated Exclusion Decrease in 2026**.

If the increased gift and estate exclusion amount were permanent, clients would be better off using zero-out transfer planning (such as GRATs) while saving their gift and estate exclusion amounts. Assets that would otherwise have been gifted would remain in the estate, would be covered by the estate exclusion amount (other than subsequent appreciation after the time the asset would have been gifted), and would receive a basis adjustment at death. The planned decrease of the estate and gift exclusion amount, however, changes that calculus because if the increased exclusion amount is not used during the window of opportunity before 2026, it is lost.

b. **Lifetime Gifts of Low Basis Assets; "Appreciation Hurdle."** The estate tax savings of gifts are offset by the loss of a basis step-up if the client dies no longer owning the donated property. For example, assuming a 40% estate tax rate and a 25% rate on capital gains (20% + 3.8% NIT + assumed 1.2% state rate) a gift of a $1 million asset with a zero basis would need combined net income/appreciation of 166.667%, and grow to $2,666,667 (to a value that is 267% of the current value) in order for the estate tax savings on the *future* growth ($1,666,667 x 40%) to start to offset the loss of basis step-up ($2,666,667 x 25%).

David Handler refers to the "appreciation hurdle" as the aggregate (not annual) combined net growth required between the date of a lifetime asset transfer and the date of the transferor's death for the estate tax savings to equal the capital gains tax cost. It is derived using the following formula:

Capital Gains Tax Rate x (1 - Basis as % of Asset Value) / (Estate Tax Rate - Capital Gains Tax Rate).

David has produced the following chart to reflect the appreciation required, expressed as a percentage of the asset value at the date of the gift, depending on the asset's basis.

If basis is this % of value	Aggregate appreciation required to meet the hurdle (%)	$100 would grow to this amount
0%	166.667%	$266.67
10%	150.000%	$250.00
20%	133.333%	$233.33
30%	116.667%	$216.67
40%	100.000%	$200.00
50%	83.333%	$183.33
60%	66.667%	$166.67
70%	50.000%	$150.00
80%	33.333%	$133.33
90%	16.667%	$116.67
100%	0.000%	$100.00

The average annual return required depends on how long the donor lives after the gift. For example, if the donor lives 10 years after the gift and if the gifted asset has a basis of zero, annual growth of 10.31% would produce the aggregate required growth of 166.667%.

Applying this analysis shows that surprisingly, transferring a significantly slower-growing asset with a high basis may provide a greater tax benefit than a faster-growing asset with a low basis. For example, compare two assets each currently worth $1 million. Asset A has a basis of $100,000 and grows at 8% per year; Asset B has a 900,000 basis but grows at only 4%. Assuming a constant rate of return, after 10 years Asset A will grow to $2.15 million and Assets B will grow to $1.48 million. If the donor dies in ten years, transferring **Asset A** would have a net tax **COST** of **$52,500** (($1.15 million post-transfer appreciation x 40% estate tax rate) - ($2.05 million taxable gain x 25% tax on capital gains) = -$52,500), and transferring **Asset B** would have a net tax **BENEFIT** of **$47,000** (($480,000 post-transfer appreciation x 40% estate tax rate) - ($580,000 taxable gain x 25% tax on capital gain) = $47,000). Giving Asset B, growing at only 4% per year, would be better than giving Asset A, growing at 8% per year, if the donor lives another 10 years after the gift.

c. **Recovering Basis Adjustment of Gifted Assets at Death**. Various planning alternatives may result in "recovering" the basis adjustment at death for gifted assets. "Call me before you die-we may need to make some adjustments."

(1) **Swap for Equivalent Value**. If the gift was made to a grantor trust, the donor could exercise the "swap power" for cash. The cash transferred to the trust would still be out of the estate; the appreciated asset would be back in the donor's estate and would receive a basis adjustment at death. This is a very important advantage of making gifts to grantor trusts.

If the donor does not have available cash, the donor may be able to arrange for a line of credit at a bank. On a moment's notice, the donor could borrow funds to pay cash to the grantor trust in the swap transaction. If the donor transfers a promissory note as consideration for the swap, the tax results are uncertain; the basis of the note in the hands of the grantor trust may be either zero or 100% of the face value of the note. Partnership cases indicate that a self-created note gets no basis, but C corporation cases have said that a shareholder can obtain 100% basis for a self-created note.

If a swap for a note is the only transaction the donor is willing to consider, why not try it? (Even if the note has a zero basis, the following planning alternative using disregarded entities may result in the note's disappearance without cancellation of indebtedness income.) See Item 43.b below.

(2) **Repurchase from Disregarded Entity**. Assume that a gift is made of an interest in an LLC that owns real estate. If the LLC is a disregarded entity, with the donor as the deemed owner, the donor could repurchase the real estate from the LLC at a later time (maybe even if it has a negative basis). When the real estate is purchased in its entirety, no discount would apply. In effect, the donor may have transferred a minority interest in the LLC at 70% (with a 30% discount), but later repurchase the underlying real estate at 100%, resulting in a valuation arbitrage as well as recovering the basis adjustment at death with respect to the gift.

This is one reason that implementing transfer planning with disregarded entities, owned by the donor and various grantor trusts or other disregarded entities that are deemed owned by the donor, can be very advantageous.

(3) **Triggering Estate Inclusion**. If the donor has excess estate exclusion amount, the donor may prefer that the gift asset be included in the donor's gross estate to get a basis adjustment, to the extent that including the asset in the estate will not result in additional estate taxes.

(i) ***Third Party Authority to Grant Limited Power of Appointment to Grantor*.** Conceivably, one way of triggering estate inclusion might be for a third party to exercise flexibility under the trust instrument to grant a testamentary limited power of appointment to the donor. Two concerns arise with this planning alternative.

First, even if the power is granted, some have raised concerns as to whether the decedent would be treated as having a tax sensitive power in light reasoning in *Estate of Skifter v. Commission*er, 468 F.2d 699 (2d Cir. 1972) and Rev. Rul. 84-179. If the settlor acquires a power of appointment because of a reformation or decanting transaction that is not initiated by the settlor, *Skifter* may prevent triggering §2038, but if the power is granted pursuant to an authority that the settlor gave to the third party in the agreement, it is more likely that estate inclusion would result. See Item 3.i.(1) of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

Second, and more important, Treas. Reg. §20.2036-1(b)(3) provides that §2036 applies even if a power is merely exercisable in conjunction with other persons (whether or not adverse) and regardless of whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death. That arguably might cause the grantor to be treated as holding the limited power of appointment for purposes of §2036(a)(2) even if the power was never actually granted.

(ii) ***Donor Use of Property***. The donor might use trust property in some way that would reflect an implied agreement of retained enjoyment to cause estate inclusion under §2036 (such as using property without paying adequate rent). The court rejected the IRS position, however, that the decedent's continued occupation of a residence without paying rent following the end of the term of a QPRT required inclusion under §2036(a)(1) where the estate demonstrated that the decedent had intended to pay rent but the rent documentation and payment had simply not been completed before the decedent died. *Estate of Riese v. Commissioner*, 2011 T.C. Memo. 60.) Even so, planners ask "what's the harm" in taking the position that §2036 would apply?

(iii) ***Move Trust Situs***. If the donor is a discretionary beneficiary of the trust in a domestic asset protection (DAPT) state, move the trust situs to a state that does not have DAPT provisions, which would cause §2038 to apply "because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust." Rev. Rul. 76-103, 1976-1 C.B. 293.

(iv) **Powell *as Rationale for Estate Inclusion for Basis Adjustment Purposes***. If a decedent dies owning an interest in an FLP or LLC, the *Powell* reasoning provides a rationale for including the entity's assets (rather than the discounted interest in the entity) in the estate (at least as to interests retained by the decedent or transferred within the prior three years) as long as the transfer to the partnership did not qualify for the bona fide sale for full consideration exception to §2036. Arguments from prior rulings and case law that oral understandings or allegations as to the "true substance" of a transaction cannot be used to bootstrap into estate inclusion arguably would not apply, because the *Powell* reasoning does not depend on implied agreements, oral understandings, or deviating from the actual form and substance of the entity (though the IRS could argue that contribution of assets to the entity was a bona fide transfer for full consideration). Many of those cases involve a taxpayer that later took a position inconsistent with the manner in which a transaction was reported on a tax return. *E.g., In re Steen v. United States*, 509 F.2d 1398, 1402-1403, n.4 (9th Cir. 1975). Having previously reported a contribution to an FLP or LLC as a gift (or as a non-gift) transaction on a gift tax return would not be inconsistent with filing an estate tax return after the decedent's death reporting the assets as includible in the estate under §2036(a)(2). Do not consider this alternative if the estate wishes to qualify for the marital deduction with respect to the FLP or LLC interest. See item 12.d.(3) of the Heckerling Musings 2019 and Other Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

(v) ***Estate Tax Return Not Required for Basis Adjustment***. Regulations clarify that the basis adjustment under §1014 is permitted even though no estate tax return is filed and no estate tax is paid. Treas. Reg. §1.1014-2(a)(2).

40. Private Derivative Contracts

Public derivatives are commonly sold on the open markets. For example, an investor may purchase a derivative that will make payments based upon the future performance of particular assets (e.g., tracking stocks, Dow Jones Industrial Average, industry-specific indices, prices of commodities, changes in the weather, etc.). A *private derivative* is an agreement entered into between family members (or trusts for their benefit). The amount due under the contract may be based on the performance of some asset that is not actually transferred.

If a client owns an asset with a very low (or negative) basis that has high appreciation potential, the client may achieve the transfer tax advantages of shifting wealth based on the future appreciation of the asset without actually transferring the asset out of the client's estate, so that a basis adjustment will be available at the client's death.

The derivative contract can be customized as desired. For example, instead of transferring all future appreciation of an asset for X years the contract might enable the grantor trust that purchases the contract just to receive future appreciation over $Y million or to receive Z% of the future appreciation.

Significant tax complications arise if the derivative contract is not closed out prior to the client's death.

Use an appraiser to value the contract (somewhat like valuing options). Also, use a formula sale with a price adjustment clause to avoid current gift taxation in case the IRS questions the valuation.

For a summary of David Handler's comments regarding general planning with private derivatives, see Item 15 of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.** ***See*** **David Handler*, Naked Derivatives and Other Exotic Wealth Transfers,*** 50th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 8 (2016).

41. Partnership Basis Stripping and Shifting

Assume (in a greatly oversimplified example) that a partnership has two assets, one with a high basis and one with a low basis, and assume the assets have been in the partnership for over 7 years so that there are no mixing bowl or disguised sales rules that apply. The partnership wants to sell or re-depreciate the low basis asset, so would like to achieve a basis adjustment for that asset. The preferred approach is to make a liquidating distribution of the high basis asset to the older partner. The distribution results in the older partner receiving the asset with a zero basis (assuming his outside basis in his partnership interest was zero). (This is referred to as a "basis strip.") He will die with the zero-basis asset and get a full basis step-up, not impacted by discounting of the partnership interest. As long as a §754 election is in place, the stripped basis that was lost (when the high-basis asset was distributed, converting it into a zero basis asset) is moved to the low-basis asset remaining in the partnership for the benefit of the younger partners. The estate could contribute its high-basis asset (after the basis step-up at death) back into the partnership.

The net effect of this strategy is (a) an immediate full basis step-up on the asset for which a basis adjustment is needed, (b) not limited by valuation discounts, (c) basis has effectively been moved from one high basis asset to another low basis asset, (d) this was accomplished without anyone dying, and (e) without gain recognition.

Achieving this result in a real world situation beyond the oversimplified facts described above requires complex partnership tax structuring. The complex structuring includes using partnership divisions (to separate a particular high basis and low basis asset into a separate partnership, and to make the §754 election just for that separate partnership; if the partners keep the same percentages in the separated partnerships, both of them are considered continuation partnerships without any change in §704(c) responsibility.)

For a detailed discussion of basis planning with partnerships, see Paul S. Lee, *Modern Uses of Partnerships in Estate Planning*, 50th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 3 (2016); Paul S. Lee, Cassady V. Brewer, Ellen K. Harrison, *Venn Diagrams: Meet Me at the Intersection of Estate and Income Tax*, 48th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 3 (2014).

42. Using Debt to Maximize Basis Adjustment

Some planners have suggested that the prime planning strategy should be to acquire lots of assets by debt. Professor Ed McCaffery summarizes this prime planning strategy in four words: "Buy, borrow, and die." The gross value of the assets would receive a basis adjustment.

Using debt also can facilitate transfer planning when the client wants to retain low basis assets to take advantage of a basis step-up at death.

a. **Debt to Facilitate Transfer Planning**. Assume that an individual owns a $10 million asset with no basis. Instead of using that asset for transfer planning, which would cause a loss of the basis adjustment at the individual's death, the individual could borrow $9 million cash using the asset as collateral. Hopefully, the $9 million in cash can be transferred from the estate using various transfer planning alternatives (zeroed-out transfers, discounts, gift exclusions, etc.) or if not, the $9 million of cash could be used to swap for another $9 million low-basis asset that is in a grantor trust. The $10 million asset itself is still included in the gross estate at $10 million (assuming the individual is personally liable for the debt), but the $9 million debt may be deducted (assuming it is a bona fide debt for consideration).

   Conventional thinking has been that the borrowing must be for recourse debt in order for this strategy to work. The debt must be bona fide and for adequate and full consideration. §2053(c)(1)(A). If the debt is non-recourse (i.e., if the client is not personally liable for the full amount of the debt), only the value of the property net of the non-recourse indebtedness is included as an asset of the gross estate on Schedule A of the estate tax return. Reg. §20.2053-7; s*ee* Instructions to Schedule A, Form 706.

The full debt can be deducted even if the property is valued at less than fair market value under the special use valuation rules. Rev. Rul. 83-81; Reg. §20.2053-7.

Those requirements are described as "conventional thinking" because the IRS may be adjusting its analysis as reflected in the basis consistency proposed regulations. The basis consistency proposed regulations and the instructions to Form 8971 suggest that the gross value of property subject to non-recourse indebtedness qualifies for basis adjustment, not just the net value. Prop. Reg. §§1.1014-10(a)(2), 1.1014-10(e) Ex. 4. The September 2016 revised Instructions to Form 8971 clarify that values to be reported on Schedule A are the estate tax values, without reflecting any post-death adjustment in value, and are the full gross values of property, unreduced by "mortgages, non-recourse indebtedness, or other decreases in equity."

b. **Debt to Finance Swap Transaction.** This same approach would apply if the grantor borrows from a bank to purchase appreciated assets from a grantor trust. For example, if a client with a $10 million estate repurchases $9 million of low basis assets from a grantor trust, using borrowed funds to make the cash payment, the client's gross estate would be $10 million + $9 million of assets received from grantor trust, or $19 million. The full $19 million would receive a basis step-up, but would have a taxable estate of just $10 million with a $9 million debt deduction). If the client were able to get some of the $9 million of proceeds out of the estate using transfer planning strategies, the net taxable estate would be even lower.

c. **Effect of Trust Debt on Beneficiary Estate Inclusion**. If steps are taken to cause trust assets to be included in a beneficiary's estate (see Item 44 below), issues could arise as to the value that is included in the beneficiary's estate for assets subject to debt (for example, if the grantor had sold the asset to a grantor trust and the trust still owes the note to the grantor). Unless the beneficiary is personally liable for the debt, the asset may be treated as an asset subject to nonrecourse indebtedness, such that only the net value is included in the beneficiary's gross estate and the basis adjustment would be limited to that amount. This result may be avoided if the beneficiary personally guarantees the debt. See Turney P. Berry & Richard B. Covey, *Planning and Drafting for the Married Couple in an Era of Mobility, Portability and Liability*, 50th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 11, ¶1103.1.B (2016). This conventional thinking may be changing as discussed in Item 42.a above,

d. **QTIP Assets Subject to Debt.** A similar advantage for debt in a QTIP trust associated with QTIP assets included in a surviving spouse's estate under §2044 is likely not available. What if a QTIP trust owns appreciated assets worth $5 million with outstanding debt of $3 million? Is $5 million of assets include in the gross estate under §2044 with a $3 million debt deduction? Section 2044(c) says: "For purposes of this chapter and chapter 13, property includible in the gross estate of the decedent under subsection (a) shall be treated as property passing from the decedent." Does this mean that $5 million is included in the estate (with a $3 million deduction) or just the net $2 million value? Furthermore, if the decedent does not owe the $3 million debt, it may not be deductible under §2053. Section 2053(b) allows the deduction of administration expenses for administering property not subject to claims (which would include expenses of administering QTIP property, *see* TAM 9121002), but no similar explicit provision applies regarding debt claims. The estate may be in a better position to argue for full inclusion and a debt deduction if the decedent guarantees the loan or if joint and several liability of the trust and the decedent exists for the debt.

43. Debt in Excess of Basis in Grantor Trust at Grantor's Death

a. **General Income Tax Treatment of Prior Sale to Grantor Trust Transaction at Grantor's Death**. In a typical sale to grantor trust transaction, the grantor sells assets to a grantor trust in return for a note secured by the assets. If the grantor trust converts to a nongrantor trust during the grantor's life, most believe that a recognition event occurs with respect to the unpaid note. However, if the conversion to a nongrantor trust does not happen until the grantor's death, uncertainty exists regarding the treatment of the grantor's note and the assets held by the grantor trust.

The IRS may have given up on arguing that a sale recognition event occurs at death if the grantor still holds a note from the grantor trust at death. Chief Counsel Advice 200923024 concluded that converting a trust from nongrantor to grantor trust status was not a taxable event. An interesting statement in the CCA is relevant to the commonly asked question of whether gain recognition occurs on remaining note payments at the death of the grantor if the grantor has sold assets to a grantor trust for a note. In addressing the relevance of "Example 5" (Reg. §1.1001-2(c) Ex. 5), *Madorin*, and Rev. Rul. 77-402, the CCA observed:

> We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner ***which is generally not treated as an income tax event.*** (emphasis added)

Furthermore, the qualified opportunity funds proposed regulations take the position that if a grantor gives an interest in a qualified opportunity fund to a grantor trust, the gift is not an "inclusion event" that triggers realization of the deferred income on the fund. It also says that the loss of grantor trust status during the grantor's life does trigger the deferred gain, but the death of the grantor (and subsequent distribution of assets from the grantor trust by reason of the grantor's death) does not trigger the deferred gain. Prop. Reg. §1.1400Z2(b)-1(c)(4)-(5). Now something more authoritative than a CCA states the government's position that death is not a realization event–a proposed regulation takes the position that the death of a grantor is not a realization event with respect to "deferred recognition assets" in a grantor trust.

Most planners believe that the grantor's installment note does receive a basis step-up (on the theory that it is not IRD, because if payment had been made during the grantor's life, it would not have been treated as realized income). However, most planners also believe that the basis of assets that have been sold to the grantor trust do not receive a basis adjustment at the grantor's death.

While death may not be a realization event for realizing remaining gain on the note, the IRS has not necessarily given up on making a traditional *Crane* argument that a deemed transfer of assets from the grantor to the trust at the grantor's death (when the trust becomes a non-grantor trust) with an associated liability (the note from the trust) in excess of basis results in gain under the *Crane* doctrine. Disregarded entity planning may be able to avoid that result.

b. **Disregarded Entity Planning to Avoid Recognition of Debt in Excess of Basis at Grantor's Death.** The grantor and grantor trust might create an LLC that is a disregarded entity. The grantor trust had purchased assets from the grantor for a note and contributes those assets (subject to the note) to the LLC. The grantor contributes various assets to the LLC, including the note. Because the same entity owes the liability and also owns the associated receivable, the liability disappears. Because this was done in a disregarded entity, no taxable event should result. On the grantor's death, the LLC is converted to a partnership rather than a disregarded entity, because there is no longer a single member for income tax purposes. The deemed transfer should be treated as an asset purchase and contribution, providing a full basis adjustment.

When the grantor dies, his interest in the LLC will be valued taking into consideration appropriate discounts. If a §754 election is in effect, an inside basis adjustment would be made, but seemingly only up to the discounted value of the LLC interest. However, a basis adjustment should result without the discount. Paul Lee explains.

> Upon the death of the grantor, there is a deemed transfer of 50% of the LLC to the trust (no longer a grantor trust) which converts the disregarded entity to a partnership for tax purposes under situation 1 of Revenue Ruling 99-5. … [S]uch a conversion is treated as an acquisition of the LLC assets by the members and a contribution of those assets to a new partnership. Significantly, if the conversion is treated this way, then for step-up in basis purposes, the estate does not own a 50% interest in a partnership, rather the estate is deemed to own 50% of the assets which are simultaneously contributed to a partnership at death. As such, the estate should be entitled to claim a step-up in basis under section 1014(a) of the Code for 50% of the value of the asset in the LLC without risk of losing basis due to valuation discounts.
>
> Under sections 722 and 723 of the Code, the estate should have an outside basis in the LLC of $50x, and the LLC should have an inside basis of $50x on the asset which is worth $100x. Practitioners taking this position will likely want to report the inclusion of 50% LLC asset in the estate of the grantor, rather than a 50% interest in the LLC, and out of an abundance of caution, ensure that the LLC makes a section 754 election, entitling it to an inside basis adjustment under section 743(b), in case there is a question as to whether the LLC has $50x of inside basis on the asset.

44. Basis Adjustment Planning for Beneficiaries

Planning to leave open the flexibility to cause trust assets to be included in the gross estate of a trust beneficiary if the beneficiary has excess estate exclusion will continue to be important to permit a basis adjustment at the beneficiary's death without generating any added estate tax.

Four basic approaches can be used:

(1) making distributions to the beneficiary (either pursuant to a wide discretionary distribution standard or under the exercise of a non-fiduciary nontaxable power of appointment, but beware that granting an inter vivos power of appointment exercisable during the settlor's lifetime might cause the trust to be a grantor trust, *see* §§ 674(a), 674(b)(3));

(2) having someone grant a general power of appointment to the beneficiary (but consider including the broadest possible exculpatory clause for that person, and providing that the person has no authority to exercise the power until requested to consider exercising the discretion to grant the power by some designated persons or class of persons);

(3) using a formula general power of appointment (perhaps adding that a non-adverse party could modify the power of appointment to add flexibility; structure the formula based on the lesser of the individual's remaining GST exemption or applicable exclusion amount, and limit the formula to $10,000 less than that amount so that the existence of the general power of appointment will not require the powerholder's estate to file an estate tax return); or

(4) triggering the Delaware tax trap by the exercise of a nontaxable power of appointment to appoint the assets into a trust of which a beneficiary has a presently exercisable general power of appointment.

To limit the possible "inappropriate" exercise of a power of appointment, (i) grant a testamentary power that some independent person has the power to remove before the powerholder dies, (ii) specify that the power is exercisable only with the consent of some other non-adverse party (but not the grantor), *see* Reg. §20.2041-3(c)(2)Ex. 3, and (iii) limit the permissible appointees of the power (such as to persons related by blood, marriage, or adoption or to creditors).

To the extent that general powers of appointment are used for basis adjustment purposes, bear in mind that the existence of the general power may have creditor effects, but the actual exercise of a testamentary general power of appointment may be more likely to subject the assets to the decedent-beneficiary's creditors than if the general power is not exercised.

For a detailed discussion of various basis adjustment planning alternatives (including various form provisions), see Item 5 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

45. Upstream Gifts or Other Gifts to Moderate Wealth Individuals; §1014(e)

Many parents of clients will have no federal estate tax concerns, even if the parents live past 2025 when the exclusion amount returns to $5 million (indexed). While the gift tax exclusion amount is $10 million (indexed), a client may give/sell assets to a grantor trust for a third party (such as a modest-wealth parent of the client) who will have a testamentary general power of appointment in the trust. At the parent's death, the inclusion of the assets in his or her estate may generate no estate taxes but the assets would receive a basis adjustment (although issues could arise under §1014(e) if the parent dies within a year of when the client creates the trust), and the parent could allocate his or her GST exemption to the assets. The assets might pass by default into a trust for the client's benefit but that would not be in the client's estate for estate tax purposes. For a detailed discussion of this planning alternative, see Item 7.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

If the client wants to use an upstream transfer but does not want to use the client's gift tax exclusion amount in doing so, a GRAT could be used with the remainder interest passing to an upstream trust for the client's parents. Alternatively, the client might make a "seed gift" to an upstream grantor trust and sell assets to the trust in return for a note. For a stronger argument that the full gross value of the assets, and not just the net value of the trust assets, would be included in the parent's estate for a basis adjustment under

§1014, consider having the parent guarantee the obligation. *See* Treas. Reg. §20.2053-7 ("But if the decedent's estate is not so liable [for debt in respect of property in the gross estate], only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate.") *But see Crane v. Commissioner*, 331 U.S. 1 (1947) (suggesting that basis increase is based on the fair market value of property regardless of associated debt). The basis consistency proposed regulations and the instructions to Form 8971 suggest that the gross value of property subject to non-recourse indebtedness qualifies for basis adjustment, not just the net value. Prop. Reg. §§1.1014-10(a)(2), 1.1014-10(e) Ex. 4. See Item 42.a above. For a discussion of the alternative of leveraging the amount of assets that can achieve a basis step-up at the parent's death by using a sale to an upstream trust, see Turney P. Berry & Richard B. Covey, *Planning and Drafting for the Married Couple in an Era of Mobility, Portability and Liability*, 50th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 11, ¶1103.1.B (2016).

Similarly, gifts may be made to other individuals who have no estate tax concerns in hopes of getting a basis increase at the individual's death, and taking steps to avoid §1014(e) in case the donor should die within one year of the gift (for example, by having the assets pass into a discretionary trust for the original donor's benefit rather than passing outright to the original donor, *cf.* PLR 9026036, reversed as to other issues and reissued as PLR 9321050). For a detailed discussion of planning issues surrounding §1014(e), see Item 8.c of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

46. Achieving Basis Adjustment at First Spouse's Death Regardless of Which Spouse Dies First; Limitations Under Section 1014(e) If Donee Dies Within One Year

Alternatives for achieving a basis increase at the first spouse's death include a wide variety of ideas, such as planning with community property, joint revocable trusts, a §2038 marital trust, and various "acronymed" structures, including JEST, SUPRIT, SUGRIT, and Tangibles SUGRIT. These alternatives are discussed in Item 5.g of the Estate Planning Current Developments Summary (December 2018) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** and in more detail in Item 8 of the Current Developments and Hot Topics Summary (December 2015) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

Items 47-49 are observations from a seminar by Ronald D. Aucutt, Turney P. Berry, and Professor David M. English, The Trust has Moved Under Your Feet: Do You Feel the Rules Tumbling Down? (The seminar addresses various issues about Uniform Acts, including the Uniform Trust Code and the Uniform Fiduciary Income and Principal Act).

47. Uniform Trust Code

a. **Historical Background.** The Uniform Trust Code (UTC) was completed in 2000. A Commissioner from Montana, which had few trust law cases, suggested the act, and commissioners thought that it would only be enacted in small states. It has now been enacted in 32 states plus the District of Columbia, and Illinois and Hawaii are now also considering enactment.

The Uniform Prudent Investor Act and the Uniform Principal and Income Act (now the Uniform Fiduciary Income and Principal Act, discussed below) both preceded the UTC. New developments impacting trusts include the Uniform Trust Decanting Act and the Uniform Directed Trust Act (which is now incorporated in §808 of the UTC or can be adopted independently).

b. **Non-Controversial "Successful" Provisions**. Provisions that have been enacted in most states include:

- Representation and nonjudicial settlements (§111 and Article 3)
- Trust creation (§§401-409)
- Authority of court to modify or terminate a trust (§§412-417)
- Revocable trusts (Article 6)
- The duties and powers of the trustee (Article 8)
- Trustee liability and relationships with third parties (Article 10).

c. **More Controversial Provisions, Not Uniformly Adopted**. Other provisions, which have not been uniformly enacted, include:

- Nonjudicial modification or termination by consent of the settlor and all beneficiaries (§411)
- Spendthrift provisions and the rights of a beneficiary's creditors to reach the beneficiary's interest (Article 5)
- Power of the court to remove the trustee (§706)
- Duty to keep beneficiaries informed of administration and the ability of the settlor to waive such requirements (§§105, 813).

d. **Arbitration Provisions**. A new development is the use of arbitration in provisions in trusts, and courts have begun to enforce mandatory arbitration provisions against beneficiaries. About six or seven states have enacted mandatory arbitration statutes for trusts, but the UTC has not yet added a provision.

e. **Default Rules**. Almost all of the provisions of the UTC are merely default provisions that can be overridden in the trust agreement. However, certain mandatory rules listed in §105(b) cannot be overridden. Most of the mandatory provisions have been enacted with little or no change, but states have varied significantly with respect to §105(b)(8)-(9) regarding the ability of a settlor to waive otherwise mandatory rules on trustee disclosure (discussed below).

f. **Representation (Article 3)**. The ACTEC State Laws Committee had been working on a project regarding representation since the 1980s, and the UTC incorporated some of that work. The most discussed issues were virtual representation and the extent to which holders of powers of appointment can represent and bind interests that are subject to the power.

g. **Non-Judicial Settlement Agreements (§111)**. A major change was to permit virtual representation for non-judicial settlements (traditionally that was available only for judicial settlements). Section 111 establishes standards for the enforcement of non-judicial settlements and contains an illustrative list of possible settlement matters.

h. **Power of Beneficiaries to Modify/Terminate a Trust (§411)**. Section 411 codifies the general common law rule that a settlor and all beneficiaries could modify or terminate a trust. In 2004, discussion emerged regarding whether this provision created a §2036 issue. The tax effects of §411 have never been resolved, but §411(a) now provides various options including (1) court ratification of a settlor/beneficiary decision and (2) making the provision prospective only.

   Section 411(c) originally provided that a spendthrift provision was not presumed to constitute a material purpose, but following considerable controversy, that provision has been placed in brackets. Some states have deleted the provision and others have flipped the presumption.

i. **Judicial Modification/Termination (§§412-416)**. Methods provided for a court to modify or terminate a trust include (1) modification/termination because of unanticipated circumstances (§412), (2) small trust termination (§414), (3) reformation (§415), and modification to achieve the settlor's tax objectives (§416).

j. **Spendthrift/Creditor Rights (Article 5)**. Spendthrift provisions were not part of the British common law, but the concept was invented by 19th century U.S. courts. State laws vary significantly particularly as to (1) "exception creditors" not subject to a spendthrift provision, and (2) methods whereby creditors can reach a beneficiary's interest. Another significant issue is whether and to what extent a beneficiary's interest constitutes "marital property" for purposes of divorce divisions.

   The UTC does not include a provision authorizing self-settled spendthrift trusts.

   Despite statutory provisions recognizing spendthrift trusts, some courts have refused to recognize the protection, particularly with respect to tort creditors. *E.g.*, *Sligh v. First National Bank of Holmes County*, 704 So.2d 1020 (Miss. 1997). Turney Berry quips that "courts have an annoying tendency to want to 'do the right thing.'"

k. **Trustee Removal (§706)**. The Code follows the traditional grounds for court removal of trustees including serious breach of trust, unfitness, unwillingness, and lack of cooperation among co-trustees. It expands unfitness to include persistent failure to administer the trust effectively. The Code also adds newer grounds for court removal of a trustee, including for substantial change of circumstances or if requested by qualified beneficiaries.

l. **Powers to Direct (§808)**. The provisions regarding the ability to give someone the power to direct trustee decisions in the Restatement (Second) of Trusts §185 were codified in §808 of the Code. As originally drafted, it was relatively brief. In 2017, §808 was replaced with the detailed Uniform Directed Trust Act, which can be enacted as §808 of the UTC or can be enacted independently.

m. **Duty to Keep Beneficiaries Informed (§813) and "Silent Trust" Provisions (§105)**. Relatively little common law exists regarding the duty to make disclosures to beneficiaries. Section 813 has separate rules for three classes of beneficiaries – current beneficiaries, qualified beneficiaries, and "all" beneficiaries. Prof. English summarizes:

   - The current distributees have the greatest rights, such as the right to receive the trustee's annual report.

- The trustee owes an obligation to the next broader group, the qualified beneficiaries, to keep them generally informed of administration as well as informing them of a number of discrete items, such as the trustee's acceptance of office.
- Beneficiaries who are neither current distributees or qualified, have the least rights but do have the right to ask questions of the trustee and receive a response.

Sections 105(b)(8)-(9) limit the settlor's ability to waive the disclosure requirements. States have varied significantly as to their treatment of these provisions. Some states have deleted subparagraphs (8)-(9) of §105(b) entirely, implying that a settlor may provide that the trust may be kept totally secret. Other states allow the settlor to designate surrogates to receive notice on behalf of certain types of beneficiaries, or allow the settlor to waive the required notice but not the obligation to respond to beneficiary requests for information.

One court concluded that, despite the statutory provision allowing a settlor to waive notice to beneficiaries, beneficiaries always have a right to information reasonably necessary for them to enforce their rights. *Wilson v. Wilson*, 690 S.E.2d 710, 711 (N.C. Ct. App. 2010).

n. **Choice of Law (§107); Conflict of Laws**. Section 107 allows a settlor wide discretion in selecting the law governing the trust.

> SECTION 107. GOVERNING LAW. The meaning and effect of the terms of a trust are determined by:
>
> (1) the law of the jurisdiction designated in the terms unless the designation of that jurisdiction's law is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue; or
>
> (2) in the absence of a controlling designation in the terms of the trust, the laws of the jurisdiction having the most significant relationship to the matter at issue.

This statutory provision leaves significant uncertainties in its application to any particular situation. A comment to the Code specifically recognizes the difficulty of formulating any specific rules and states that "[t]his section does not attempt to specify the strong public policies sufficient to invalidate a settlor's choice of governing law. These public policies will vary depending upon the locale and may change over time."

Thirty of the 32 jurisdictions that have enacted the UTC have enacted some form of §107 (1). Fourteen jurisdictions have made substantive changes. These provisions are summarized in Tom Gallanis, *The Use and Abuse of Governing-Law Clauses in Trusts: What Should the New Restatement Say?*, 103 IOWA L. REV. 1711 (May 2018).

48. Giving Powers and Beneficial Interests to an Entity

Turney Berry raises the prospect of giving certain authorities to a state law entity (such as an LLC) rather than to an individual. The entity would be perpetually in existence and may be located in any jurisdiction. For example, §405(c) of the UTC gives the settlor of a charitable trust the ability to enforce the trust; could a single-member LLC created by the settlor be given that authority? Under the Uniform Directed Trust Act, any person may be a trust director, and a person includes entities. Could an LLC be designated as a trust director? (See Item 100.e below.) Could a power of appointment be given to and an entity such as an LLC?

Furthermore, at least conceptually, a trust could include LLCs as discretionary beneficiaries rather than individuals.

Turney suggests "pondering" these possibilities while waiting on planes during inevitable flight delays.

49. Uniform Fiduciary Income and Principal Act

Ron Aucutt was the Reporter of the Uniform Fiduciary Income and Principal Act (UFIPA), which was approved by the Uniform Law Commission in July, 2018. The historical background and major changes in UFIPA are described below.

a. **Historical Background**. UFIPA is an update of the previous Uniform Principal and Income Acts (UPIA) approved in 1931, 1962, and 1997. The 1997 version is sometimes called the Revised Uniform Principal and Income Act (RUPIA), which was itself amended in 2008.

b. **Retention of Familiar Default Rules**. Many of the default rules in RUPIA were retained. Indeed, the allocation of receipts provisions in Article 4 and the allocation of disbursements provisions in Article 5 were largely kept intact. UFIPA kept 19 of the 21 RUPIA general rules in Articles 4 and 5 with the same section numbers, including all 15 of the frequently consulted substantive provisions regarding the allocation of receipts in §§401 through 415.

c. **Name**. The new Uniform Fiduciary Income and Principal Act adds the word "Fiduciary" (which is defined to include personal representatives and trust directors as well as trustees) and moves "Income" before "Principal" (emphasizing that principal may be "what's left" after income is paid out). Most conveniently, the new acronym UFIPA will not be confused with the UPIA, the same acronym for the old Uniform Principal and Income Act and the Uniform Prudent Investor Act.

d. **"Special Tax Benefit," §102(19)**. The Uniform Trust Decanting Act includes extensive explicit safeguards to prevent decanting from jeopardizing intended beneficial tax characteristics of the trust. Adopting the same approach, UFIPA describes four kinds of "special tax benefits" that are preserved with special limitations. These include (1) qualification of an income interest for the gift tax annual exclusion, (2) eligibility for "qualified subchapter S trust" (QSST) treatment, (3) eligibility for the estate or gift tax marital deduction, and (4) total or partial exemption of the trust from the generation-skipping transfer tax.

   The power to adjust income and principal under §203(e)(1), the option to forgo "insubstantial" allocations under §408, and the power to convert to or from a unitrust or change a unitrust under §309(b) are limited for these four special tax benefit situations.

e. **Expanded Power to Adjust, §203**. The power to adjust between income and principal in §104 of RUPIA was available only if three conditions were met: (1) "the trustee invests and manages trust assets as a prudent investor;" (2) "the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income;" and (3) "the trustee determines… that the trustee is unable to comply with" the requirement that a trustee "administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries." RUPIA §§104(a) and 103(b).

Section 203 of UFIPA eliminates those three conditions. The power to adjust exists regardless of the terms governing distributions, and regardless of whether the fiduciary would be "unable" to be impartial without adjusting. Section 203(a) changes the condition to: "if the fiduciary determines the exercise of the power to adjust will assist the fiduciary to administer the trust or estate impartially." Factors are listed in UFIPA, just as they were in RUPIA, to be considered when exercising the expanded power to adjust, except that they have been updated to match contemporary views of trusts, §201(e).

In addition, UFIPA allows the power to adjust to be exercised not just year-by-year, but over a number of years, so long as it continues to be prudent to make the adjustment.

The power to adjust may only be exercised by a fiduciary that is "independent," which is defined in §102(11) for a trust to be a person who is not a qualified beneficiary, a settlor, or any individual whose legal obligation to support a beneficiary may be satisfied by distribution from the trust. In addition, the person must not be a spouse, parent, sibling, or issue of any of those individuals, an entity in which those persons have voting control, or an employee of any of the above.

f. **Power to Convert to a Unitrust, (Art. 3)**. UFIPA does not absolutely limit the unitrust rate to 3-5% or limit the valuation period to calendar years. (However, unitrusts are limited to the 3-5% rate with only annual averaging if a trust has certain attributes, like GST grandfathering or a marital deduction, §309(b).) The power to convert to or change from a unitrust is available if "the fiduciary determines that the action will assist the fiduciary to administer a trust impartially."

   Unlike the power to adjust, a fiduciary that is not "independent" may convert to or from a unitrust or change a unitrust. If the fiduciary is not "independent," however, the 3-5% rate with only annual averaging requirement applies, §309(b).

g. **Governing Law, §104**. UPIA and RUPIA did not have governing law provisions. Questions regarding the distribution of trust property might be considered construction issues that would be governed by the law of the settlor's domicile. However, UFIPA, like a rule of administration, is governed by the law of the situs or principal place of administration of the trust (which is not necessarily the place where all or most of the trust assets are located), §104. That "workable" position is consistent with §§107-108 of the UTC and §3 of the Uniform Directed Trust Act. Section 104 explicitly states that the governing law rule may be superseded by adding an express provision in the terms of the trust.

h. **Receipts from Entities**.

   (1) **Income**. Except as provided below (for purchase of part of the fiduciary's interest in the entity or for "capital distributions"), distributions of money or tangible personal property of a nominal value are treated as income. §401(c).

   (2) **Principal**.

   (i) Distributions of property (other than money or tangible personal property of a nominal value) are treated as principal. §401(d)(1).

   (ii) Distributions of money in exchange for part or all of the fiduciary's interest in the entity reducing the fiduciary's interest relative to other persons are treated as principal. §401(d)(2).

(iii) Distributions of money from a regulated investment company (i.e., a mutual fund) or real estate investment trust that are received as capital gain dividends for federal income tax purposes are treated as principal. §401(d)(4)(A).

(iv) Distributions of money that the fiduciary determines or estimates are capital distributions (discussed further in the following subparagraph) are treated as principal.

(v) The comments to §401 add that if the fiduciary decides to reinvest dividends, the new shares so acquired are treated as principal) reinvested dividends are treated as principal. Making such an election is equivalent to making an adjustment from income to principal under §203.

(3) **Capital Distribution.** To "determine or estimate" whether money distributed from an entity is a capital distribution, the following rules apply.

(i) First, the fiduciary may rely without inquiry or investigation on how the entity characterizes the distribution, unless the fiduciary determines on the basis of information known to the fiduciary that the characterization is or may be inaccurate, or the fiduciary owns more than 50% voting interest in the entity, §401(d)(e)(1).

(ii) Next, the fiduciary may determine or estimate that the total amount of money and property received by the fiduciary in the entity distribution or a series of related distributions is or will be greater than 20% of the fair market value of the fiduciary's interest in the entity, §401(e)(2). RUPIA discussed this in terms of a "total or partial liquidation" and used a test based on total distribution from the entity exceeding 20% of the entity's gross assets. Changing to a test of whether the distributions to the fiduciary exceeds 20% of the fiduciary's interest in the entity simplifies the fiduciary's inquiry.

(iii) If neither of those apply, the fiduciary may consider various factors listed in §401(f), which includes "any other factor the fiduciary determines is relevant."

(iv) If the fiduciary determines that part of an entity distribution is a capital distribution but the amount that is a capital distribution is in doubt, the fiduciary shall allocate to principal the amount of the entity distribution that is in doubt. §401(g).

(v) If the fiduciary receives additional information before part of the entity distribution is made to a beneficiary, the fiduciary may change a decision before making the payment. If the fiduciary receives additional information after making a distribution, the fiduciary is not required to change or recover the payment to the beneficiary but may consider that information in determining whether to exercise the power to adjust under §203. §401(h)-(i).

Items 50 - 65 are observations from a seminar by Terence M. Franklin, Michael D. Simon, and Matthew Triggs, The Ethics of Negotiation: Oh, the Places You Can't Go

50. Negotiations are Commonplace

Many of the things that attorneys do involve negotiation. Things such as mediation, or preparing settlement papers obviously involve negotiation, but talking with a client about the initial engagement letter or making changes to the engagement letter also involves negotiations. Ethical rules apply to various matters that may end up involving negotiation.

51. Engagement Letter

The engagement letter is an ideal place to address many issues that may later lead to conflict and negotiation. The best way to avoid negotiation is to address and resolve issues before they arise. These can include matters such as issues relating to joint representation, defining the role of other lawyers involved in the representation, limitations on liability, clarifying who is or is not a client.

"The gap between expectations and reality is called disappointment."

52. Scope of Representation

Attorneys owe various duties to their clients, including the duty of competence, loyalty, and of zealous advocacy. Clearly defining the scope of the representation in the engagement letter limits the circumstances to which those duties apply.

Rule 1.2(c) of the ABA Model Rules of Professional Conduct (the "Model Rules") state that "a lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent."

53. Persons to Whom Duties Are Owed

The engagement letter should make very clear who the attorney is and is not representing.

a. **Agents of Clients; "Agent Letters."** As an example, an elderly client's son may attend all meetings, and the son may reasonably form the belief that the attorney is advising him as well. The engagement letter should make clear that the attorney is only representing the elderly client and no one else. The letter can clarify that the attorney has requested the son to attend meetings to assist in communicating with the client. The letter would clarify that the son is the client's agent and that the attorney is authorized to disclose attorney-client communications with him as a part of the representation of the client.

   Separately, the attorney should write the son an "Agent Letter" making clear that he is not the attorney's client, and that a written engagement letter will be required for him to become a client. The letter should remind the son that privileges may exist in communications between the attorney and the elderly client, and the son must keep those communications confidential.

b. **Duties to Persons Who Are Not Clients**. In some circumstances, the attorney may owe duties to someone to whom the client owes a duty, such as a client who is a fiduciary for trust beneficiaries, or who is a guardian for a ward. For example, the court in *Saadeh v. Connors*, 166 So. 3d 959 (Fla. 4th DCA 2015) allowed the ward to proceed with a professional negligence claim against the attorney who represented the ward's temporary guardian.

c. **Know Who's at the Table**. In any meeting, the attorney should know everyone at the table, and whether the attorney is representing them or not. No confusion should exist about how everyone at the table relates to the attorney-client relationship.

54. Informed Consent

Informed consent is an agreement by person to a proposed course of conduct after the lawyer has communicated adequate information about the risks and benefits of reasonably available alternatives to the proposed course of conduct. Informed consent requires clearly explaining alternatives and the risks and benefits of proceeding under the various alternatives.

Providing sufficient advice to obtain informed consent is one of the most difficult things that lawyers do, and many ethical rules are tied to informed consent.

Document the information provided in obtaining the client's informed consent. Documentation is essential to show that the necessary information was communicated and that the client understood it adequately.

55. Communications with Clients

a. **Set the Right Tone at the Outset**. The attorney should set the proper tone for the client relationship at the outset. Clarify that the attorney will be frank and forthright with the client in discussing various issues, not because a problem exists, but because keeping the client appropriately informed is important to the relationship. With the right tone, when a client subsequently receives a letter from the attorney describing some issue, the situation will not be awkward, and the client will not immediately assume that a problem exists. The letter is sent to protect the client as well as the attorney.

b. "**Risks and Benefits" Letters**. In the process of documenting that the attorney has adequately informed the client, the attorney may send various risks and benefits letters. Clients may ask why the attorney is repeatedly sending letters about the risks and benefits of various alternatives and why the client must pay the attorney for sending letters confirming what the client knows. The attorney should explain that the letters are a benefit for both the client and the attorney.

c. **Impact of Duty of Loyalty**. Situations may arise in which a conflict of interest arises between the attorney and the client. The attorney has a fiduciary relationship with the client, and owes a high duty of loyalty and fidelity. When conflicts exist (for example, if the client wants to convert an hourly fee arrangement to a contingent fee arrangement), situations may exist in which the attorney should advise the client to get independent representation with respect to that particular issue.

   Juries might not understand a lot of things, but they understand one thing really well – loyalty. The same with clients, especially if the attorney has represented the client for a long time.

   Especially if an issue arises regarding breach of the duty of loyalty, the attorney will want to be able to produce a document showing that the issue was appropriately communicated.

56. Negotiations Involving Fiduciary Duties

A significant difference exists between arms-length negotiations and negotiations about a fiduciary relationship. In most situations, a presumption arises that parties are negotiating at arms-length. The party alleging that a fiduciary relationship exists must prove that fact.

Many things that can be done in an arms-length negotiation are permissible in negotiations involving a fiduciary relationship. Determine specifically what issues are involved in the fiduciary relationship.

57. Settlement without Paying Attorney Fees

A frequently recurring situation that can raise the duty of loyalty issue is if a party offers to settle for a certain amount, but will not pay the client's attorneys' fees. When the attorney explains that the client would be required to pay fees personally rather than out of the trust (for example), the client cringes, and a conflict exists. That is one of those types of potential conflict situations that should be addressed in engagement agreements.

When representing trustees, the engagement letter should say that attorneys' fees are typically paid by the trust under the trust law or the terms of the document, but in some situations, a court may disallow attorneys' fees. The client acknowledges that if the court does not award attorneys' fees from the trust, the client was still be personally liable for the attorneys' fees.

58. Contingent Fee Engagements

In a contingent fee engagement, potential conflict issues can arise if a settlement offers a residential property, an annuity payable over a long period of time, some illiquid asset, or an asset with significant sentimental but little intrinsic value or something that is hard to value. The engagement letter should specifically address that the goal of the representation is to obtain monetary recovery, and that if the client seeks another type of recovery that will not permit a timely payment of fees, the attorney has the right to object or revisit the fee structure. The engagement letter could address how to value assets in determining the amount of the recovery, or how to calculate present values for amounts that are paid over time.

59. Who Has Authority?

a. **Authority in the Attorney-Client Relationship**. Model Rule 1.2(a) provides that the client is the boss, and that the lawyer should abide by the client's decisions about whether to settle and the terms of settlement, no matter how unreasonable the client's position is.

   A client can give the attorney settlement authority without communicating further with the client. Model Rule 1.2 comment [3] provides that "[a]bsent a material change in circumstances and subject to Rule 1.4 [which addresses informed consent], a lawyer may rely on such an advance authorization." Despite the possibility of advanced settlement authority, settlement offers frequently come with caveats and the panelists generally would go back to the client to fully explain the settlement offer in order to be sure of having informed consent.

b. **Authority on Behalf of Opposing Party**. In any negotiation involving an opposing party, the attorney should be clear not only regarding authority from his or her own client, but also as to who has authority to make settlement decisions for the opposing party. If the opposing party is not present, confirm with opposing counsel or a mediator whether the attorney has authority to enter into an agreement. Ask for a letter or other document indicating that the person has settlement authority on behalf of the opposing party, or require that the opposing party be present.

60. Can the Attorney Withhold or Sanitize the Flow of Information?

Assume that two sons are fighting over an estate, and the will names both of them and says they are to receive equal shares. However, in a mediated setting, the opposing counsel says that the client is not entitled to an equal share because the dirty family secret is that he is not really the parent's son. The attorney knows that if that information is relayed to the client, the client will be very emotionally upset and settlement discussions will end. Arguably, the attorney could withhold communicating that information, because it is not relevant (the will specifies by name both and says they are to share equally). From an ethics standpoint, the safest call is to provide full disclosure, but the attorney as a practical matter should use good judgment as to irrelevant information to the issue at hand, particularly if the attorney thinks that it is just a negotiating ploy.

On the other hand, if the will leaves to the testator's "issue" the allegation that the client is not a blood relative is material information and will obviously be a central issue in the negotiation.

In any event, withholding or sanitizing information becomes challenging and potentially risky.

61. Confidentiality as to Information that Might Harm Another Client

Client confidences cannot be revealed without client authorization (with informed consent or implied authorization) with certain limited exceptions (to prevent a client from committing a fraud, to prevent bodily injury, etc.). An attorney cannot even drop hints that might lead another person to discover information.

An example of a troubling confidentiality scenario is if Client A tells the attorney that a big development will be happening in the future in a certain area, and Client B owns a parcel in that area. Client B asks the attorney about selling that parcel currently. The attorney knows that if Client B waits to sell, the property will become worth multiple times its current value.

In those types of situations, very few situations exist in which that kind of information can be revealed even though the attorney might think that doing so would be fair. "Sit on the sideline even if someone gets hurt."

62. Clients Talking Directly to Each Other

If an attorney believes that relevant issues or settlement offers are not being presented and proposed to the opposing party in the proper manner by his or her attorney, the attorney cannot communicate directly with an opposing party who is represented by counsel, but can the attorney advise the client to talk with the opposing party and advise what to say? Model Rule 4.2 prohibits a lawyer from talking directly with the opposing party, but how much can a lawyer do without violating Rule 8.4 (a), which prohibits the attorney from violating the Rules "through the acts of another?"

A lawyer can advise a client that the client has the right to talk with the other party and can assist with the communication. ABA Opinion Letter 11-461 concludes that a lawyer may give substantial assistant to a client regarding a substantive communication with a represented adversary including topics to be addressed and strategies to be used.

However, the attorney cannot advise the client to persuade the opposing party to do something without giving the opportunity to consult with counsel and make a fully informed decision. For example, instructing a client to ask for materials from the other side or to garner admissions is probably going too far.

63. Using Threat of Criminal Prosecution

Using a threat of criminal prosecution to gain an advantage in civil litigation does not violate the Model Rules if several facts exist: (1) the criminal matter is related to the civil litigation; and (2) the lawyer is not attempting to exert improper influence over the criminal process. (An ABA Opinion takes that position.) However, if the sole purpose is just to coerce the opposing party into settlement, uncertainty may exist. Model Rule 4.4(a) prevents using means that have no substantial purpose other than to embarrass, delay, burden, or violate the legal rights of such person.

The type of situation in which threatening criminal action would be appropriate is if the attorney thinks someone stole money and tells the person either to give it back or the attorney will sue civilly and report the matter to the police. That is appropriate. What cannot be done is to threaten that if the money is not returned, the attorney will contact Homeland Security to report that the person's visa has expired.

A federal statute, 18 USC 3, says that if one agrees not to report a felony in exchange for money, the person is guilty of a crime. However, that has been interpreted to say that if the agreement is merely to give back the person's money, that is just returning the person's own property and therefore the person did not "get money" not to reporte a crime.

64. Using Threat of Bar Grievance

a. **Threat of Filing Bar Grievance Against Another**. If the attorney thinks that facts exist to support a threat, the attorney is *required* to report under Rule 8.3 (Reporting Professional Misconduct). However, if unsubstantiated, the report violates Rule 8.4 (Misconduct, including dishonesty, fraud, deceit or misrepresentation).

   A scenario in which the discussion might be appropriate, however, might be if the attorney says he thinks that another attorney may have forged a will. "If we keep going, I'm going to dig into that. If you did something bad, I will have to report you."

b. **Agreement to Avoid Threat of Bar Grievance**. An attorney cannot ask for an agreement in a negotiation that the other party will not file a bar grievance against the attorney.

65. Attorney Directed Not to Disclose Diminished Capacity

Assume that a client who is showing signs of dementia instructs the attorney not to disclose the signs of dementia to others. The attorney subsequently thinks the client is significantly worse, and again expresses concerns to the client, but the client again tells the attorney not to tell anyone about the dementia. Can the attorney express concerns to a third party to protect the client? Disclosure of a lack of capacity can adversely impact the client's interest in a very serious manner; the family may attempt to institutionalize the client and take away all of his or her freedoms.

Panelists agreed this is a tough question. Does the attorney let the client "drive the bus off the cliff"?

Model Rule 1.14(a) provides that if a client's capacity is diminished, the attorney should as far as reasonably possible, maintain a normal client-lawyer relationship.

However, Model Rule 1.14(b) states that if the attorney thinks that the client with diminished capacity is at risk of substantial physical, financial, or other harm unless action is taken and cannot adequately act in the client's own interest, the lawyer may take reasonably necessary protective action, including consulting with individuals or entities that have the ability to take action to protect the client. Comment [5] to Rule 1.14(b) provides that "[i]n taking any protective action, the lawyer should be guided by such factors as the wishes and values of the client to the extent known, the client's best interests and the goals of intruding into the client's decision-making autonomy to the least extent feasible, maximizing client capacities and respecting the client's family and social connections."

Model Rule 1.14(c) states that in taking protective action pursuant to paragraph (b), the lawyer is impliedly authorized to reveal information about the client, but only to the extent reasonably necessary to protect the client's interests.

Comment [8] to Model Rule 1.14 observes that raising the question of diminished capacity could lead to proceedings for involuntary commitment, but states that a lawyer is impliedly authorized to make necessary disclosures in taking protective action pursuant to paragraph (b) "even when the client directs the lawyer to the contrary." The comment concludes: "The lawyer's position in such cases is an unavoidably difficult one."

Items 66-73 are observations from a seminar by Margaret G. Lodise, S. Andrew Pharies, and Dana Chidekel, Ph.D, ABPdN, ABN (Tarzana, California), Warring Siblings, Second Spouses, and Quirky Personalities: The Neuroscience and Handling of Difficult Beneficiaries. Dr. Dana Chidekel is a clinical psychologist and provides insights into the neurological and psychological factors in dealing with family conflict situations.

66. The Ingredients of Personality; What Motivates an Individual

At any given moment, behaviors are following on a continuum between automatic (habitual) and controlled (effortful) behaviors. We need both and to be able to shift between them. The automatic is for what is predictable and familiar, and the controlled is for what's novel and requires flexibility. The effective individual maintains a dynamic relationship between them in a constantly changing environment.

Some people prefer routines, and others prefer novelty. **A very important factor in being able to motivate other people is understanding whether a person is more motivated by potential rewards or by avoiding negative consequences.** For example, in mediation some parties will be most highly motivated by avoiding risk (years of litigation expenses will result if a settlement is not reached), and others will be most highly motivated by achieving something (look at all the assets that will be left for you if you don't go to court). Attorneys tell their clients that frequently everyone loses something in mediation and walks away unhappy – that can be a successful mediation in the sense of reaching a settlement, but a better result occurs if the parties are able to find a way that each wins something.

67. Family Systems

Family system theory is that systems survive when all interrelated, interdependent parts play their roles. If one element changes, either (1) the system pulls the renegade back into the role that has been played by that member or (2) all elements change and rebalance.

End-of-life scenarios impose pressures on family systems. Often, adult siblings (and parents) who haven't cohabited for 30 or 40 years must reengage intensively, long-term, in relation to an existential threat (an awareness of mortality), and aware that this is a "last chance" to get appreciation, money, or an apology.

In stressful family situations, family members under stress tend to dig into their old roles (and ideas). "Mom loved you more!" "You are so bossy!" "You never help!" "You are so selfish!"

68. Why Change is Hard, What the Brain Is Doing; Family Fighting May Be a Way of Maintaining Connections

The brain's job is to keep us alive. Familiar behaviors conserve resources. Reward circuits fire when expectations are met (even bad ones). "I knew my sister would be a jerk!" The brain does not care if you're happy; it is just conserving resources by triggering familiar behaviors.

In warring family situations, realize that is how family members know how to interact. To them, "family" may be tied up with fighting. They get their identity from what has been familiar. Fighting may be a way of keeping the family together. A family will fight at the end of the day if they are bound to do that, and that is how they know to have relationships. They fight with each other, but they feel connected. They may feel inclined to sustain that connection.

69. Equalization v. Fairness

Clients often want equal treatment of children to avoid family disruption, but there is no such thing as equalization. Perceptions will differ among family members. If grandparents do something that they view as part of their duty (paying for college), children may view the activity as unequal if one child has two children and another has three. Impress upon clients that the goal is fairness, not equalization.

70. Communication from Parent about Reasons for Estate Planning Decisions

Can family conflict be minimized if the parent writes a letter explaining reasons for estate planning decisions? That can potentially lead to legal problems, and some clients will fear that relationships with children will be impacted if some are mad or disappointed with decisions that are being made.

The planner should understand, however, that (1) you can't make everyone happy, and (2) even if everyone gets exactly the same things, if the family system revolves around conflict, the family members will find a way to interpret the activities to create conflict.

Writing precatory guidelines or letters of wishes can be beneficial, but can also raise their own problems if filled with ambiguities.

Raising issues with children while the parents are alive gives the children an opportunity to be mad at mom and dad, but if the parents don't deal with the issues, the kids will just fight with each other. Parents can make the choice of which they would prefer. Some parents' perspectives will be that they do not want to spoil the years that they have left with their children. The last surviving parent will be particularly reluctant to upset the caregiver- child.

71. Adjusting to Loss Following the Death of a Parent

At a time when the family is in severe stress, litigation steps have to be taken almost immediately to meet time deadlines. Children may not yet be at the stage of accepting that mom and dad are gone, and they can become nonfunctional in the middle of litigation following a parent's death. Eventually, they will accept that they have endured a big loss. Attorneys should constantly check with clients regarding their motivations as family litigation proceeds.

Anger can be a defense against grief.

72. Who to Select as Trustee?

Clients often just choose the oldest child to be the trustee of the family trust. However, children should be prepared for what is involved in being a trustee. They should be aware that conflict situations will often arise, and determine whether they are able to deal with conflict and make plans to minimize it.

One approach is to have the parents meet with selected children one at a time and get their input about trustee selection.

The planner might tell the family "being an executor is not an honor but a burden. We will tell you the child has been selected as the executor, and then tell the others their good news."

Appointing all of the children as trustee is often a complete disaster. One of the speakers once heard a judge tell an Estate Planning Council audience that half of her docket would be eliminated if planners would stop appointing co-trustees as fiduciaries of trusts.

73. Attorney Being Perceived as Not Zealously Advocating for Client

When an attorney talks with a disgruntled beneficiary, if the attorney shows some degree of reasonableness with the other side, the client may feel like the attorney will not represent them assertively. Clients do not want to hear "I've been doing this for 30 years, and I have a good sense of where this is going and where it will end up." But the attorney should give the client the right advice even if that means losing them because the clients do not view them as aggressive advocates for their position. (Dr. Chidekel suggests that the attorney give the advice, and then observe "I understand how this upsets you, and this is not what you were expecting it all." This does not mean the attorney is agreeing with the client but just understanding the way the client feels. The goal is for the client to understand that the client is not upset with the attorney, but with the situation.)

Items 74-86 are observations of a seminar by Cynthia G. Lamar-Hart, John C. Moran, and Diana S.C. Zeydel, Changing or Unwinding Irrevocable Trusts: Modification, Decanting, Reformation, and More

74. Reasons for Changing an Irrevocable Trust

Examples of reasons for changing an irrevocable trust include changes or clarifications in law that impact the trust, creditor protection, fixing errors and ambiguities, changed circumstances, the existence of another state that may have more favorable law, adding powers of appointment, changing trustee provisions, combining or separating trusts, creating or terminating grantor trust status, addressing a beneficiary's disqualification from receiving public benefits, removing or adding beneficiaries, an immediate need by a beneficiary of money, extension of the trust term, changing administrative provisions, the divorce of a beneficiary, differing investment philosophies among beneficiaries, and as a way to help resolve litigation disputes.

75. Historical Background Regarding Trust Modification

Trust modifications were allowed under English law, but American law (first stated in *Claflin v. Claflin*, 20 N.E. 454 (Mass. 1889), generally does not allow early termination or modification of an irrevocable trust if it would be contrary to a material purpose of the settlor. The Restatement (Third) of Trusts §64 states the general rule that "the trustee or beneficiaries of a trust have only such power to terminate the trust or to change its terms as granted by the terms of the trust." Section 65 of the Restatement provides that "if all the beneficiaries of an irrevocable trust consent, they can compel the termination or modification of the trust," unless the termination or modification would be inconsistent with a material purpose of the trust, in which event the settlor's consent or (if deceased) a court approval of a determination that the reason for termination or modification outweighs the material purpose must be obtained.

Modern trust law embraces the ability to modify or terminate irrevocable trusts, as reflected in the Uniform Trust Code (UTC), in §§411-416, and additional statutory provisions in various states. The UTC has been adopted in 35 states, and may be adopted by two more states this year. Tools for modifying trusts include construction, reformation, decanting, nonjudicial modification, and judicial modification.

76. Identification of Governing Law

The governing law of a trust determines which tools are available and who are necessary parties to the modification. Changing the place of administration might be possible to change the governing law to a state that allows a tool that is particularly favorable in a given situation.

77. Identification of Necessary Parties

The necessary parties to implement a modification vary depending on the alternative that is used, but consist of some combination of (1) the settlor, (2) the trustee, and (3) beneficiaries (or under the UTC, qualified beneficiaries).

a. **Settlor**. The settlor includes a testator, the person named in a trust instrument as creating the trust, and persons who contribute property to the trust.

b. **Beneficiary**. A beneficiary is a person who has a present or future beneficial interest in the trust, whether vested or contingent, and also includes someone who, in a capacity other than as trustee, holds a power of appointment over the trust.

   Some states have added an explicit exception, providing that *permissible appointees* under a power of appointment are not beneficiaries for this purpose. That is probably clear in any event, but questions conceivably could arise in a state that does not add that specifically. This could be very troubling if the permissible appointees include a very broad range of people (such as everybody in the world other than the power holder's estate or creditors of the power holder's estate).

c. **Qualified Beneficiaries**. Under the UTC, a qualified beneficiary is someone who is (1) a permissible distributee of trust income or principal, (2) someone who would be a permissible distributee if the interests of the distributees described in clause (1) terminated without causing the trust to terminate, or (3) would be a permissible distributee if the trust terminated on that date. UTC §103(13). Generally, this means that first-tier remaindermen are included, but second and third tier remaindermen (for example, under a "wipeout" clause) are excluded as qualified beneficiaries.

78. Representation of Parties in Nonjudicial Settlements or Judicial Modifications

For purposes of delivering required notices and obtaining necessary consents for any of the modification tools, rules govern who represents minors, unborns, incapacitated beneficiaries, beneficiaries whose identity and/or location are unknown, permissible appointees under a power of appointment (in the unlikely event that they are qualified beneficiaries), and takers in default under powers of appointment.

The representative can be either an actual or virtual representative. An actual representative is determined based on the individual's relationship with the represented party. A virtual representative is based on an individual's holding substantially identical interests in the trust as the represented beneficiary.

The theory of virtual representation is that if an individual has a substantially identical interest, the person will represent his own interests and in doing so will adequately represent others with identical interests.

a. **General Limitations, Including No Conflict of Interest**. The representative must not have a conflict of interest with respect to the particular question at issue in the modification. In addition, a settlor may never represent a beneficiary in a nonjudicial consent modification under UTC §411(a). Comments to §411 of the UTC indicate that the requirement that no conflict of interest be present means that virtual representation will rarely be available for trust terminations, but "should be routinely available in cases involving trust modification, such as a grant to the trustee of additional powers."

b. **Actual Representation – Based on Relationship**.

   Family Members. A parent (if there is no conflict of interest) can represent his or her own minor or unborn child (unless a conservator or guardian has been appointed for the minor child, in which event that fiduciary is the actual representative). UTC §303(6); TEX. PROP. CODE §114.032(c).

Some states allow actual representatives for more remote relationships, such as allowing an individual to represent his unborn issue and even minor issue.

Some states provide priority between parents who both want to represent a minor child. Of those states that do, the general approach is to provide that the parent who is also a beneficiary of the trust or whose ancestors created the trust has priority. (Wyoming takes a different approach, giving the parent with primary custody priority.)

Some states (such as New Hampshire) allow a parent or grandparent to represent an adult child who is incapacitated and for whom no conservator or guardian has been appointed. (Using that authority is problematic if the statute does not define "incapacity" for this purpose.)

Fiduciaries. In addition to family members, certain fiduciaries can be actual representatives, including a conservator, a guardian of the person if there is no conservator, an agent under a power of attorney, a trustee with respect to trust beneficiaries (even if the beneficiary is adult and competent), and a personal representative with respect to persons interested in the decedent's estate. UTC §303(1)-(5). Some states provide that the trustee's actual representative authority does not apply to internal affairs but only to external matters.

Powerholders. In addition, certain powerholders can serve as actual representatives. The holder of a general testamentary power of appointment can represent permissible beneficiaries and takers in default if there is no conflict of interest. UTC §302. The holder of an inter vivos general power of appointment is treated as the functional equivalent of the settlor of a revocable trust, meaning that the inter vivos powerholder can act directly without the necessity of representing anybody else. Some states (not the UTC) also permit the holders of a *special* power of appointment to represent permissible appointees.

c. **Virtual Representation- Based on Having Substantially Identical Interests**. A beneficiary can be represented by a person with a substantially identical interest with respect to the particular question if there is no conflict. UTC §304; TEX. PROP. CODE §114.032(d) (another beneficiary who has a substantially identical interest and who is an ascendant of the represented person). Under UTC §304, virtual representation can apply broadly to "a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable," but applies only if the representing person has a substantially identical interest with respect to the particular question or dispute and only to the extent no conflict of interest exists. This can be either horizontal (the person represented is in the same class or has the same level of beneficial interest as the representative) or vertical (the person represented has a beneficial interest that is successive to the representative's interest-- meaning that first tier remaindermen can represent second or third tier remaindermen).

   Traditionally, the doctrine of virtual representation applied only to judicial proceedings. Under the UTC, the concept also applies to nonjudicial settlement agreements or modifications.

d. **Bootstrapping Representation**. The extent to which representation can be "bootstrapped" is not clear. For example, may an individual representing a beneficiary under actual representation also represent another beneficiary that the represented beneficiary would be permitted to represent by virtual representation? The answer is not clear but some planners are doing it.

e. **Priority among Representatives.** May a permissible virtual representative leapfrog a permissible actual representative to represent a particular individual? An uncertainty arises because §304 of the UTC recognizes virtual representation for a person "unless otherwise represented." However, those words may mean "unless there is a court appointed representative," and may not refer to other people who could be actual representatives of the person.

79. Construction

A construction proceeding interprets a document as signed. It is not really a tool for modifying trusts, but may allow construing trust terms in light of current conditions. It often involves an ambiguous document.

For tax purposes, the IRS generally recognizes that the interpretation relates back to the date of execution of the instrument, as discussed in Item 86.f below. Parties may be creative in finding ways to achieve the desired result in a construction proceeding as opposed to other modification alternative in order to get this retroactive effect for tax purposes.

80. Reformation

The law of reformation is generally summarized in §415 of the UTC, which provides that a court may reform the terms of a trust, even if unambiguous, to conform to the terms of the settlor's intention if the proponents prove by clear and convincing evidence the settlor's intention and that the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement. Section 2-805 of the Uniform Probate Code has a similar provision regarding the reformation of will.

A mistake of expression occurs when the terms of the trust misstate the settlor's intention, fail to include a term that was intended, or include a term that was not intended to be included. A comment to §415 of the UTC says that scrivener errors often cause mistakes of expression.

A mistake in the inducement occurs when the terms of the trust accurately reflect what the settlor intended, but the intention was based on a mistake of fact or law.

The clear and convincing evidence standard is a high standard. For example, a Florida court concluded that the testimony of a drafting lawyer was not sufficient to satisfy the standard in that case. *Reid v. Sonder*, (Fl. 3d DCA 2011). If the settlor is still alive, his or her testimony would be very important.

A reformation proceeding can add language or delete language from a document in order to conform to the settlor's intent.

A statute of limitations probably does not apply to bar a reformation action, but the laches doctrine can apply, for example if the beneficiary waits to bring a reformation action until after the settlor has died (when the settlor's testimony as to his or her intent would no longer be available).

A key advantage of a reformation proceeding is it relates back to the creation of the trust. It involves a situation with no ambiguity, and a construction (which would also relate back to the creation of the trust) will not achieve the desired result.

Key Elements:

- Judicial action required.
- Some scrivener will likely have to "fall on its sword."
- An attorney ad litem will likely be appointed to represent minors or unborn beneficiaries.
- May have retroactive effect (though the IRS may not agree, see Item 86.f below).
- Establishing the settlor's intent by clear and convincing evidence will be easier if the settlor is still alive to testify as to his or her intent.

81. Decanting

a. **General Description**. Three states have recognized a common law concept of decanting. *Phipps. v. Palm Beach Trust Company*, 142 Fla. 782 (1940); *Wiedenmayer v. Johnson*, 254 A.2d 534 (N.J. Super Ct. App. Div. 1969); *In Re: Estate of Spencer*, 232 N.W.2d 491 (Iowa 1975). The general premise is that a trustee that has the unfettered authority to make distributions to a beneficiary could instead make the distribution into a trust for the benefit of that beneficiary.

   A number of states now have decanting statutes, and the Uniform Trust Decanting Act was approved in July, 2015. For a detailed summary of the Uniform Decanting Act, see Items 11-17 of the ACTEC 2015 Fall Meeting Musings (summarizing a seminar by Susan Bart and Amy Heller, moderated by Benjamin Orzeske) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For various resources about the tax effects of decanting, see Item 81.n below.

   The state statutes vary, but many of them draw a distinction between trusts with unlimited distribution powers and those with some limitations.

b. **Principal Invasion Right.** The trustee must have the ability to invade principal for the benefit of one or more of the beneficiaries.

c. **Limited Discretion.** If restrictions on distribution standards are present (typically limited to an ascertainable standard or reasonably definite standard), the trustee may decant the principal to a second trust as long as the beneficial interest of each beneficiary of the second trust is substantially similar to that person's beneficial interest in the first trust. (Uniform Decanting Act, §12(b), (c).) This limitation means that generally only administrative provisions can be changed in the new trust (the interest of each beneficiary must be substantially similar to that person's interest in the first trust). (In some states [Indiana is an example], decanting is not permitted at all unless the trustee has an absolute power to invade principal not limited by a standard.) Some state statutes are more lenient; for example Delaware's statute would allow the second trust to further restrict purposes for which distributions can be made, but the distribution standard could not be broadened.

d. **Expanded Discretion.** If the trustee has expanded distribution discretion (for example, "best interests," "welfare" or no standard), the second trust may have different dispositive provisions, with limits that protect "vested rights" and that protect qualification for various tax advantages. No acceleration of remainder interests can occur, and no new beneficiaries may result. Some changes are permitted with respect to adding or restricting powers of appointment.

e. **Power of Appointment.** Some of the decanting statutes (Delaware and Nevada are examples) allow giving a beneficiary a power of appointment that was not in the first trust.

   Under the Uniform Decanting Act, the new trust can grant a new power of appointment to a beneficiary only if the original trust provided expanded discretion regarding distributions. For a trust with expanded discretion, under the Uniform Act, the second trust may:

   - Retain a power of appointment that is in the first trust;
   - Omit a power of appointment that is in the first trust other than a presently exercisable general power of appointment;
   - Create or modify a power of appointment if the powerholder is a current beneficiary of the first trust; or
   - Create or modify a power of appointment if the powerholder is the successor or presumptive remainder beneficiary of the first trust as long as the exercise of the power is delayed until the powerholder becomes (or would become if living) a current beneficiary. §11(d).

   The power of appointment in the second trust may be general or nongeneral. The class of potential appointees under the power of appointment may include persons who are *not* beneficiaries of the first trust. §11(e).

f. **Removing and Adding Beneficiaries.** In certain states, the decanting statute may be used to *remove* some beneficiaries in the existing trust. For example, this might be helpful to divide a pot trust into separate trusts for each beneficiary. (Although the trustee may have the *power* to remove a beneficiary, the trustee may breach its fiduciary duty in doing so unless sound reasons exist for that action.)

   None of the state statutes allow *adding* beneficiaries by decanting. An indirect way of adding a beneficiary is to decant into a new trust that gives a beneficiary a power of appointment (if that is permitted in the state statute), and the beneficiary can exercise the power of appointment to appoint the assets into a trust including a new beneficiary.

g. **Cannot Eliminate Fixed Rights.** The decanting may not be used to eliminate fixed rights (such as a mandatory income interest). Under the Uniform Decanting Act, vested interest (which may not be eliminated) includes a noncontingent mandatory distribution right (such as the right of a beneficiary to withdraw at age 30 if the beneficiary has not yet reached age 30), a current noncontingent right to receive distributions (such as a right to receive income that is in "pay status"), a presently exercisable general power of appointment, or a vested remainder interest. §11(a)(3).

h. **Notification and Consent.** The decanting power can generally be exercised without court approval or beneficiary consent (except for a few specific modifications that may benefit the trustee personally). Some states require the trustee to notify beneficiaries that decanting has occurred (or will occur–for example, the Uniform Trust Decanting Act requires 60 days advance notice, Florida requires 60 days advance notice, and Texas requires 30 days advance notice before the decant occurs). The trustee may want to give notice to beneficiaries to start the statute of limitations running on a claim by a beneficiary that the decanting was a breach of fiduciary duty. The trustee may seek court approval of a decanting.

The absence of beneficiary consent can be important for tax purposes. No gift consequences should apply to a beneficiary from a decanting because the beneficiary is not participating in the action. For example, the IRS recently refused to issue a letter ruling that a trust judicial modification to give a beneficiary a limited power of appointment (that could be exercised in favor of beneficiaries' spouses who were not currently beneficiaries) would not be gifts. The IRS was troubled because the beneficiaries' consents were required under the relevant state law for the judicial proceeding. The IRS suggested that it might view the situation differently if beneficiaries' consents were not required (for example, via decanting or merger).

i. **Fiduciary Duty; No Implied Duty to Exercise or Inform Beneficiaries of Decanting Power**. The fiduciary must act accordance with its fiduciary duties in exercising a decanting power. The fiduciary must exercise its fiduciary duties with heightened scrutiny to uphold the material purposes of the trust and to satisfy the fiduciary's duty of loyalty because it may act without beneficiary consent or court approval. Comments to §803 of the UTC remind that the duty of loyalty does not require that all beneficiaries be treated equally, but they that they be treated equitably in light of the terms and purposes of the trust. The Uniform Decanting Act explicitly states that the trustee must not violate its fiduciary duties in its exercise of a decanting power, §4(a), but the Act specifically states that it "does not create or imply a duty to exercise the decanting power or to inform beneficiaries about the applicability of" the Act. §4(b).

   A recent case highlights the duty of loyalty in the decanting context. The court held the fiduciary liable for a serious breach of fiduciary duty in undertaking a series of decantings under rather suspicious circumstances to eliminate the interests of various beneficiaries, because the trustee gave no consideration to those interests. *Hodges v. Johnson*, Slip Op. No. 2016-0130 at 11 (N.H. Dec. 12, 2017). The result of the case is rather unsettling, because it did not permit removing beneficiaries as a result of the decanting process, even though the trust instrument indicated that the trust could be administered for the primary benefit of the current beneficiaries as opposed to the remainder beneficiaries. But the facts were unusual (including three serial resignations of the trustee to substitute appointment of the settlor's attorney as trustee to exercise the decanting authority), and the trustee seemed to be merely complying with wishes of the settlor without independently exercising discretion as to whether the decanting actions were in the best interests of the beneficiaries in carrying out the purposes of the trust.

j. **Duration; Perpetuities**. The second trust may have a different duration than the first trust, but the second trust must be subject to perpetuity provisions applicable to the first trust to the extent of property in the second trust that came from the first trust. §20.

k. **Can Seek Court Approval**. Under the UTC, a nonjudicial modification can be presented to a court for approval. Similarly, the Uniform Decanting Act allows a trustee to seek court approval of whether a proposed decanting is permitted and consistent with the fiduciary duties of the trustee. §9(a).

l. **Governing Law Considerations.** The validity of the exercise of a limited power of appointment is governed by the law of the trust's situs at the time the power is exercised. Most state statutes treat the exercise of a decanting power as the exercise of a limited power of appointment, and under most state's laws, the law of the situs of the trust when the power is exercised governs the validity of the exercise of the power. If the original state does not recognize decanting, but the situs of the trust is moved to a jurisdiction that permits decanting, the decanting may be permitted even though the original state's law might continue to govern as to the validity and construction of the trust. For example, Delaware codified this concept in its decanting statute, which provides that Delaware's decanting statute is available to any trust that is administered in Delaware, notwithstanding that another jurisdiction's laws may govern the trust. 12 Del. C. 3528(f). (The *Peierls* decisions in Delaware concluded that even if the trust contains a choice of law provision that references "administration," the law governing the administration of the trust will change when the key place of administration changes via a proper appointment of a successor trustee, unless the settlor has specifically stated his or her intent that a state's laws shall always govern the administration of the trust. The concept was recently codified in Delaware. 12 Del. C. §§3332, 3340.)

m. **Should Decanting Provisions be Drafted into Trust Agreements**? If a client does not want to allow decanting, the trust agreement should specifically prohibit distributions in further trust (at least to trusts that are not substantially identical) because the applicable state statute may otherwise allow decanting or the trust administration may move to a state that allows decanting.

For a client that wishes to allow decanting flexibility, including a decanting provision in the trust allows decanting if the relevant state does not have a decanting statute, or in case the trust moves to a state without a decanting statute. In addition, the clause could draft around permissive provisions in some state statutes that could cause adverse tax consequences. (The Uniform Decanting Act can be a drafting guide because it includes various provisions designed to guard against adverse tax issues.) Furthermore, the Massachusetts Supreme Court observed that a more recent trust instrument that does not mention decanting authority might create a negative inference in light of the current general recognition the decanting authority of a trustee in exercising its discretion to make trust distributions. *Morse v. Kraft*, 466 Mass. 92 (2013).

n. **Resources**. For excellent resources regarding decanting and the tax effects of decanting actions, see Jason Kleinman, *Trust Decanting: A Sale Without Gain Realization*, 49 REAL PROPERTY, TRUST AND ESTATE LAW J. 453 (Winter 2015); Melissa Willms, *Decanting Trusts: Irrevocable, Not Unchangeable*, STATE BAR OF TEX. EST. PL. STRATEGIES COURSE, ch. 4.2 (April 2014) [also at 6 EST. PLAN. & COMMUNITY PROP. L.J. 35 (Fall 2013)]; Carlyn S. McCaffrey & Amy Heller, *Fixing Estate Planning Documents*, 48TH ANN. HECKERLING INST. ON EST. PL., ch. 15 (2014); Jonathan G. Blattmachr, Jerold I. Horn, & Diana S.C. Zeydel, *An Analysis of the Tax Effects of Decanting*, 47 REAL PROPERTY, TRUST AND ESTATE LAW J. 141 (Spring 2012); Diana S.C. Zeydel & Jonathan G. Blattmachr, *Tax Effects of Decanting—Obtaining and Preserving the Benefits*, 111 J. TAX'N (Nov. 2009). For summaries of the tax effects of decanting, see Items 63-70 of the ACTEC 2013 Annual Meeting Musings found **here** and Item 49 of the ACTEC 2015 Annual Meeting Musings, both of which are available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

o. **Key Elements**

- Non-judicial action.
- Generally only administrative provisions can be changed.
- If an unlimited invasion power applies, changing beneficial interests may be possible, including removing one or more beneficiaries (subject to appropriate exercise of the trustee's fiduciary duty).
- No beneficiaries may be added (other than perhaps by including a power of appointment that could be exercised by the powerholder to add another beneficiary).
- In some situations, eliminating some beneficiaries or restricting the interests of some beneficiaries may be possible (but a beneficiary later might question whether that is a breach of fiduciary duty).
- Beneficiary consent is not required (and ill-advised).

82. Nonjudicial Settlement Agreement (UTC §111)

a. **General Requirements**. Under §111 of the UTC, nonjudicial settlement agreements require (1) the consent of all "interested persons" whose consent would be required in order to achieve a binding settlement were a court to approve it, (2) the change "does not violate a material purpose of the trust," and (3) can only include terms and conditions that could be properly approved by a court. Item (3) is not particularly important because a court would likely approve anything that does not violate a material purpose of the trust.

b. **Necessary Parties**. "Interested persons" must be parties to the agreement. The UTC is intentionally vague about who are "interested persons." The determination depends upon the nature of the modification. The comment to §111 states that "[b]ecause of the great variety of matters to which a nonjudicial settlement may be applied, this section does not attempt to precisely define the 'interested persons' whose consent is required to obtain a binding settlement…" For almost any changes, the consents of beneficiaries will be required. (For some things a trustee's consent is needed, and for some things the consent of a settlor if living is required.)

   Observe that the consent of the settlor is not always required. This is an important distinction from the requirements of a nonjudicial consent modification under UTC §411(a), discussed in Item 83 below.

c. **Permissible Scope of Modification**. The UTC has a nonexclusive list of six matters. UTC §111(d). The common thread of this list is that, except for the first one, the others do not deal with dispositive provisions. The six items are matters relating to (1) interpreting or construing the terms of the trust, (2) approving a trustee's report/accounting, (3) directing the trustee to refrain from performing a particular act or granting the trustee a necessary or desirable power, (4) resignation/appointment of trustee and determination of trustee compensation, (5) transfer of the trust's principal place of administration, and (6) liability of the trustee for an action taken relating to the trust.

The UTC nonexclusive list of permissible matters does not address trust modifications, so they are neither expressly included nor excluded as permissible actions for nonjudicial settlement agreements. Some states have an exclusive list of permitted modifications (primarily administrative matters) because of a perceived potential for abuse. Eight states have statutes that expressly authorize nonjudicial trust modification: Florida, Illinois, Missouri, New Hampshire, Ohio, Oregon, Pennsylvania, and West Virginia. Three states expressly prohibit modification: Iowa, Michigan, and Kansas. The remaining states are silent as to trust modification by nonjudicial settlement agreement.

d. **Living Settlor Not Required**. This alternative is particularly helpful in situations in which the settlor is not living.

e. **Key Elements**

- Non-judicial action.
- The modification or termination must be consistent with the material purpose of the trust.
- All beneficiaries must participate in the agreement, but settlor consent is not required. Perhaps a parent who is not a beneficiary and who does not have a conflict of interest could represent a minor beneficiary. For virtual representation to apply, another adult beneficiary must have a substantially identical interest without a conflict of interest.

83. Nonjudicial Consent Modifications With Consent of Settlor and Beneficiaries (UTC §411(a))

a. **Distinguishing Characteristics**. Nonjudicial consent modifications under UTC §411(a) require the consent of all beneficiaries as well as the settlor. Trustee consent is generally not required (and that can be very helpful where it is not possible to get trustee consent). All types of modifications are allowed.

b. **Broad Scope Permitted**. All modifications are allowed, even if inconsistent with the material purpose of the trust (under the theory that the settlor's consent is required). Amendments made to the UTC in 2004 placed the substantive provisions in brackets, giving states various options, including the possibility of making the provision prospective and applicable only to trusts that became irrevocable after the date of enactment.

c. **Section 2036/2038 Concerns.** Some planners have questioned whether the trust is really irrevocable if the settlor and beneficiaries can modify it. Does that give the settlor the power "in conjunction with others" to modify the trust, thus triggering the application of §§2036(a)(2) and 2038? In reaction to this concern, §411(a) of the UTC was revised to stipulate that the consent of all beneficiaries is required and that the settlor could not represent them. Some states alternatively have provided that the settlor has a mere veto power, feeling more comfortable that the settlor's mere passive involvement does not trigger §§2036(a)(2) and 2038. See Item 86 below for a further discussion of the tax considerations.

d. **Key Elements**

- Non-judicial action.
- The settlor must be alive, competent, and willing to participate in the modification of termination.
- The modification or termination does not have to be consistent with the material purpose of the trust.
- All beneficiaries must participate in the agreement. Perhaps a parent who is not a beneficiary and who does not have a conflict of interest could represent a minor beneficiary. For virtual representation to apply, another adult beneficiary must have a substantially identical interest without a conflict of interest.

84. Judicial Modification (UTC 411-417)

a. **Uniform Trust Code Provisions**. The UTC has various sections addressing the judicial modification of trusts.

- Section 411(b)-Consent of all Beneficiaries. The trust may be modified or terminated with the consent of all beneficiaries if the court concludes that the modification or termination is not inconsistent with a material purpose of the trust. The court in In Re Trust of Shire, 907 N.W.3d 263 (Neb. 2018) refused to modify a trust under this section because the attorney for "unknown/undiscovered heirs" appointed by the court did not consent to the modification.
- Section 411(e)-No Consent of All Beneficiaries But Beneficiaries Adequately Protected. The court may modify a trust even though not all beneficiaries consent, (1) if the court could have modified the trust had all beneficiaries consented, AND (2) the interests of a non-consenting beneficiary will be "adequately protected."
- Section 412-Unanticipated Circumstances or Inability to Administer Trust Effectively. The court may modify the administrative or dispositive terms of the trust because of circumstances not anticipated by the settlor, but the modification must be made in accordance with the settlor's probable intention. UTC §412(a). In addition, the court may modify the administrative terms if continuing the trust on its existing terms would be impracticable or wasteful or impair the trust's administration. UTC §412(b). If the trust is terminated, the trustee shall distribute the trust property in a manner consistent with the purposes of the trust. UTC §412(c).
  Beneficiary consent is not required for modifications under this section (or under §§ 414-417, but notice must be given under §§414 and 417).
  The comments to §412 observe that Subsection (a), which addresses modifications based on unanticipated circumstances, "is similar to Restatement (Third) of Trusts Section 66 (1) (Tentative Draft No. 3, approved 2001), except that this section, unlike the Restatement, does not impose a duty on the trustee to petition the court if the trustee is aware of circumstances justifying judicial modification."
- **Section 413-Cy Pres Doctrine for Charitable Trusts**.
- **Section 414-Uneconomic Trust**. Section 414 allows termination of small trusts less than $50,000.

- **Section 415-Reformation to Correct Mistakes**. See Item 80 above.
- **Section 416-Tax Objectives**. Section 416 authorizes modifications in a manner not contrary to the settlor's probable intent to achieve the settlor's tax objectives, which modifications may have retroactive effect.
- **Section 417-Combination and Division of Trusts**. After notice to qualified beneficiaries, the court may combine trusts or divide a trust in a manner that "does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust."

b. **Division of Trusts (UTC §417)**. Merging or dividing trusts is a particular type of judicial modification that is recognized in §417 of the UTC, as cited immediately above. Most states have had statutes permitting trust divisions before the adoption of the UTC, and many instruments allow dividing a single trust into multiple trusts.

Scope of Modification. Under §417 of the UTC, the divided trusts do not have to be identical, but the division cannot "impair the rights of any beneficiary or adversely affect achievement of the purposes of the trust." For example, a trust requiring equal distributions of income to two separate beneficiaries for life could be separated into two equal trusts with one trust payable solely to beneficiary A and the other trust payable solely to beneficiary B.

Trustee is Only Necessary Party. The trustee is the only necessary party, which can be very helpful if there are any concerns with obtaining consents from others. Under §417, qualified beneficiaries must receive advance notice of the division but do not have a veto power.

c. **Key Elements**

- Judicial action required.
- Broader modification authority than all of the other alternatives.
- An attorney ad litem will likely be appointed to represent minors or unborn beneficiaries.
- Beneficiary consent may be required in some states for some types of judicial modifications.

85. Future Interests Doctrines That Have an Impact on Tax Effects of Trust Modifications

Whether trust interests are susceptible of gratuitous transfer impacts whether a modification, reformation, termination, or decanting of an interest in a trust may subject the interest holder to transfer tax. At common law, only vested interests were transferable, and contingent interests were not transferable until the contingency expired. However, under the current law of many states, a contingent interest generally is transferable unless prohibited by the instrument establishing the interest. RESTATEMENT (THIRD) OF PROPERTY (WILLS & OTHER DONATIVE TRANSFERS) §25.2 cmt.f. Another important distinction is that vested interests are not subject to the rule against perpetuities, because the interest is deemed vested. In addition, a vested interest is estate tax includable even if it is subject to later divestment.

Only slight wording differences can result in a remainder interest in a trust being either a *contingent* remainder interest or a *vested* remainder subject to divestment. For example, "to A for life, then to B if B survives A" creates a contingent remainder interest because the survival condition is part of the transfer of the remainder interest. On the other hand, "to A for life, then to B, but if B does not survive A, then to C" creates a vested interest subject to divestment upon the failure of survival.

States that have adopted Uniform Probate Code §2-707, which extends anti-lapse protection to future interests in trusts, have largely converted what would otherwise be vested remainders into contingent interests. For example, if the UPC provision applies to an interest "to A for life, remainder to B," the assets would pass to B's descendants if B failed to survive, rather than passing to B's estate to pass under his or her will or the laws of intestacy.

86. Tax Effects of Settlements and Modifications

The tax effects of court modifications, other trust modifications, decanting, and settlements are summarized in Items 42-51 of the ACTEC 2015 Annual Meeting Musings summary found **here** and available at **www.Bessemer.com/Advisor**. This Item includes several brief miscellaneous comments.

a. **Significance of State Property Rights**. Only "transfers" are subject to the transfer tax, and whether an interest is transferred depends upon fundamental state law property rights. "A fundamental premise of transfer taxation is that State law creates the property rights and interests, and Federal tax law then defines the tax treatment of those property rights. It is well-established that the Internal Revenue Code creates 'no property rights but merely attaches consequences, federally defined, to rights created under state law.' " *Pierre v. Commissioner*, 133 T.C. 24 (2009).

b. **Transfers that May be Taxed for Estate Tax Purposes**. A decedent must hold an interest in property and have the ability to transfer the interest at death for the interest to be subject to estate tax. If the interest disappears at death, because it is subject to a contingency that has not occurred, no estate tax is imposed. A contingent remainder interest, or a vested remainder interest that is subject to the anti-lapse statute will not be subject to estate tax if the remainderman dies before the life tenant.

   For example, Revenue Ruling 67-370 provides that the remainder beneficiary of a revocable trust holds an interest subject to the estate tax even if the remainderman dies before the settlor who has the power to modify the trust.

   > [I]t is not relevant to the application of section 2033 that a particular interest in property which survives the decedent's death may be either defeasible or indefeasible.
   >
   > Any determination of what would be the fair market value of a particular remainder interest like that under consideration herein would be affected by its possible curtailment or complete divestment at some point after decedent's death, in accordance with the general rules for the valuation of property which are set forth in section 20.2031-1(b) of the Estate Tax Regulations. The mere presence of these possibilities does not warrant the assignment of a merely nominal value to such defeasible interest in any case where there is still a reasonable probability that the estate will actually acquire possession of at least some substantial portion of the property in question.

Rev. Rul. 76-142 similarly includes a vested remainder interest in the estate of a decedent who dies before the life tenant, even though the interest may be reduced if the 53-year old life tenant has additional descendants.

> In making the valuation, the actuarial value of the decedent's remainder interest, ascertained by the formula set forth in section 20.2031-10(d) of the regulations, should be the starting point. Consideration should then be given to all known facts and circumstances that might tend to decrease such value, with due regard for (1) the certainty that a woman who has reached the age of 53 years will not bear children is far greater than that attends most other human affairs and (2) the unlikelihood that a woman of that age will adopt a child.

c. **Transfers that May be Taxed for Gift Tax Purposes**.

(1) **Value Separately What is Transferred to Each Donee**. Despite the contrary suggestion in Reg. §25.2511-2(a), gift tax is imposed on the property passing from the donor or to *each* donee, rather than merely subjecting a donor's aggregate loss of value to the gift tax. Rev. Rul. 93-12, 1993-1 C.B. 202.

(2) **Very Broad Application**. *Smith v. Shaughnessy*, 318 U.S. 176 (1942) states that the gift tax applies to property, defined broadly enough to include any property, however conceptual or contingent. The court held that a transfer of property granting a life estate, a remainder interest, and a reversion constituted a taxable gift to both the life tenant and remaindermen, even though the transfer was subject to a possible reversion if the donor survived the life tenant.

(3) **Failure to Enforce Legal Rights**. The modification of an irrevocable trust in which a beneficiary's contingent interest is dissolved could result in a gift by that beneficiary if he or she does not complain. (However, no gift occurs if the transfer is merely subject to the discretion of the trustee, and the beneficiary has no ability to complain about that exercise of discretion.) In Revenue Ruling 81-264, a gift occurred by allowing the statute of limitations to run on the collection of a loan to a family member. The gift occurs because the lender transfers control of the debt to the debtor under the rationale of *Estate of Lang v. Commissioner*.

Similarly, an income beneficiary's failure to exercise the power to make unproductive property productive may constitute a gift to the remainder beneficiaries. *E.g.*, PLRs 9045047, 9035029, 9035022.

(4) **Exercise of Power of Appointment**. The exercise of an inter vivos power of appointment over a trust giving the individual a lifetime income interest results in a gift of the income interest in the underlying relinquished property. Rev. Rul. 79-327. Furthermore, exercising a lifetime power of appointment to relinquish a discretionary interest in a trust also constitutes a gift, but determining the value of the gift can be difficult PLR 200243026 (referring to Rev. Rul. 75-550 regarding "the correct method of computing the value"); PLR 201122007 (IRS appeared to accept, on the basis of an affidavit submitted by co-trustee stating that distributions would be made only in the case of emergency, that distributions to the taxpayer would be limited and the value of the beneficiary's interest may be nominal).

d. **Background; *Bosch and Ahmanson***. In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967) the Supreme Court observed that legislative history regarding the marital deduction directed that "proper regard" be given to state court construction of wills.

Because the Senate stated "proper regard" rather than "final effect," the opinion concluded that state court decisions should not be binding on the issue, and that federal courts in tax cases will be bound only by the state's highest court in the matter before it.

The *Bosch* approach is applied to settlements in *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). A four-part test is used to determine if the results of a settlement will govern the tax consequences.

Effectively, the IRS seems to be taking the position that a "settlement tax" exists. The IRS is more inclined to give consideration to a court judgment, but totally ignore settlements because they are viewed as collusive transfers. The courts and national office of the IRS typically realize that the four-part analysis applies, but individual examiners are extremely suspicious of collusion in settlements.

e. **Revenue Ruling 73-142—Pre-Transaction Actions Can Avoid *Bosch* Analysis**. In Rev. Rul. 73-142, a settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the grantor *at his death*. The settlor obtained a local court construction that the settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the settlor removed the trustee and appointed another, so the settlor no longer had the removal power.

In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred *before the taxing event*, which would have been the settlor's death. The IRS agreed that it was bound by the court's ruling as well:

> In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, *regardless of how erroneous the court's application of the state law may have been.* Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.
>
> Unlike the situation in *Bosch,* the decree in this case was handed down *before the time of the event giving rise to the tax* (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such *date since the decree, in and of itself, effectively extinguished the power.* In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter. Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

If the construction or reformation proceeding final order is entered *prior to* the event that would otherwise have been a taxable event, the IRS will be bound under Revenue Ruling 73-142 even if the ruling does not satisfy the *Bosch* doctrine. .

PLRs 201723002 and 201723003 are examples of situations in which this opportunity should apply. The taxpayer reformed an irrevocable trust in a state court action to remove powers that were reserved to the grantor as a result of a scrivener's error, and the reformation was completed before the taxpayer died, which avoided estate inclusion under §§2035, 2036, or 2038. The rulings reasoned that the reformation to correct the scrivener's error was consistent with state law under the *Bosch* doctrine, but the result should have been the same even without the *Bosch* analysis.

f. **Construction vs. Reformation/Modification Proceedings**. A construction proceeding interprets a document as signed. It often involves an ambiguous document. The IRS is essentially bound regarding the availability of a marital or charitable deduction, because the interpretation relates back to the date of execution of the instrument (assuming the four-part analysis of settlement agreements under the *Ahmanson* case (see Subparagraph d above) can be satisfied).

   A reformation modifies a document, and the IRS position is generally that the reformation generally applies prospectively only. Accordingly, a post-death reformation may not result in an action causing assets to have passed to a surviving spouse or charity as of the date of death to qualify for an estate tax marital or charitable deduction. Some rulings have given reformations retroactive effect, however, in "unique circumstances." *E.g.*, PLR 201807001 (donor intended trust to be a grantor trust, which it was at the time of creation, but §672(f)(1) retroactively caused trust not to qualify as grantor trust; reformation "taken into account" as of date of trust creation).

   Planners may be creative in finding an ambiguity that can be used in a construction proceeding, rather than using a reformation/modification proceeding, in light of the more favorable tax treatment resulting from construction actions. *See Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67.

g. **Recent Rulings Regarding Tax Effects of Court Modifications**. A 2016 Chief Counsel Advice refused to give effect to a court modification for purposes of whether or not charitable distributions were made "pursuant to the terms of the governing instrument." CCA 201651013. The trust was modified to give the beneficiary a limited power of appointment in favor of charity. The IRS concluded that if the beneficiary exercised a power of appointment to make distributions to charity, a charitable deduction would not be available under §642(c) because the distribution would not be made pursuant to the terms of the governing instrument.

   A recent Chief Counsel Advice similarly concluded that assets appointed to charities under a power of appointment granted in a court modification would not satisfy the "pursuant to the terms of the governing instrument" requirement. CCA 201747005 (includes extended discussion of *Bosch* and Rev. Rul. 73-142). This conclusion seems incorrect; if the governing instrument is effectively modified under state law before the transfer to charity, subsequent transfers would seem to be made pursuant to the terms of the governing instrument in the absence of guidance under §642(c) that it looks only to the governing instrument as drafted, without valid modifications.

   A 2018 private letter ruling gave retroactive effect to a trust reformation. The trust was intended to be a grantor trust, and it was a grantor trust when created and funded. However, §672(f)(1) retroactively caused the trust no longer to be a grantor trust. It provides that the grantor trust rules do not apply except to the extent they cause a citizen or resident of the United States to be the deemed owner (and the grantor was not a United States citizen of resident), but an exception described in §672(f)(2)(A)(ii) states that the grantor trust rules can apply if only the grantor or grantor's spouse can receive distributions. The trust included the grantor's issue as beneficiaries (as well as the grantor), so the exception did not apply. That statute was passed after the trust had been funded, but it was retroactive to a date that was before the funding date. Based on the grantor's intent, the retroactive law change, and the fact that no distributions had been made, a reformation removing the grantor's issue as potential beneficiaries was given effect as of the date of the creation of the trust for the purpose of determining that the trust falls within the §672(f)(2)(A)(ii) exception. PLR 201807001.

See Item 6 above regarding recent rulings addressing the effect of trust modifications on the GST exempt or grandfathered status of the trust.

Items 87-94 are observations from a seminar by Charles A. Redd, Professor Jeffrey A. Cooper, Kim Kamin, and Pamela Lucina, Whose Will Is It – Does Settlor Intent Matter?

87. One of the Hottest Trust Law Issues; Resources

The major ongoing trend toward trust flexibility and allowing modification of irrevocable trusts (see Items 74-86 above for a detailed summary of observations about modifying irrevocable trusts) runs headlong into the notion that settlor intent is the "polestar of trust law." This clash between the trend toward increased trust modification and flexibility vs. carrying out the settlor's intent is reflected in major debates among academics, which has resulted in a wide variety of helpful resources. *E.g.*, Jeffrey A. Cooper, *Dead Hand Investing: The Enforceability of Trust Investment Directives*, 37 ACTEC L.J. 365 (2011); Jeffrey A. Cooper, *Shades of Gray: Applying the Benefit-The-Beneficiaries Rule to Trust Investment Directives*, 90 B.U. L. REV. 2383 (2010); Jeffrey A. Cooper, *Empty Promises: Settlor's Intent, the Uniform Trust Code, and the Future of Trust Investment Law*, 88 B.U. L. REV. 1165 (2008); Jeffrey A. Cooper, *Speak Clearly and Listen Well: Negating the Duty to Diversify Trust Investments*, 33 OHIO N.U. L. REV. 903 (2007) detailed overview of the emphasis on settlor intent); John H. Langbein, *Mandatory Rules in the Law of Trusts*, 98 NW. U. L. REV. 1105 (2004); John H. Langbein, *Burn the Rembrandt? Trust Law's Limits on the Settlor's Power to Direct Investments*, 90 B.U. L. REV. 375 (2010); Pamela Lucina, *That's Not What Mom or Dad Wanted: The Role of Settlor's Intent in Long Term Trusts*, TRUSTS & ESTATES (2016); Charles A. Redd, *Flexibility vs Certainty – Has the Pendulum Swung Too Far?*, TRUSTS & ESTATES (February 2015); Lee-ford Tritt, *The History, Impact, and Future of the Benefit-of-the-Beneficiary Rule*, EST. TAX & PERS. FIN. PLAN UPDATE (Dec. 2014/Jan. 2015).

88. Trust and Estate Dispute Resolution Act (TEDRA)

The Trust and Estate Dispute Resolution Act (TEDRA) in Washington and Idaho is extremely broad in allowing all of the beneficiaries of the trust to agree as to any "matter" about irrevocable trusts. "Matter" is defined very broadly and includes "[t]he determination of any question arising in the administration of an estate or trust, … that may include, without limitation, questions relating to: (i) The construction of wills, trusts, community property agreements, and other writings; (ii) a change of personal representative or trustee; (iii) a change of the situs of a trust; (iv) an accounting from a personal representative or trustee; (v) the determination of fees for a personal representative or trustee; or (vi) the powers and duties of a statutory trust advisor or directed trustee of a directed trust…." RCW 11.96A.30(2)(c). In addition, it includes the modification of trusts to meet various tax requirements and "[t]he reformation of a will or trust to correct a mistake…"

TEDRA recognizes the virtual representation concept with respect to obtaining the agreement of all trust beneficiaries. The written agreement is binding and conclusive on all persons interested in the estate or trust. Any party may file the written agreement (or a memorandum of the agreement) with the court having jurisdiction. Once filed, the agreement will be deemed approved by the court and is treated as a final court order binding on all interested persons.

The authority of all trust beneficiaries to enter into binding agreements regarding trusts under TEDRA is considered to include the authority to modify or terminate trusts for any reason. *See* Gail E. Mautner & Heidi L.G. Orr, *A Brave New World: Nonjudicial Dispute Resolution Procedures Under the Uniform Trust Code and Washington's and Idaho's Trust and Estate Dispute Resolution Acts*, 35 ACTEC J. at 159, 176 (2009).

Parties who want to use the very flexible provisions of Washington or Idaho law might be able to cause the trust to shift its place of administration to one of those states. *See* UTC §108.

89. Settlor Intent

Settlor intent has been referred to as the polestar of trust law. The primacy of settlor intent is an American law development (first reflected in an 1889 Massachusetts case); English law accords far less deference to settlor intent but focuses on the interests of beneficiaries and has long permitted trust beneficiaries to modify trusts. Under the American "Claflin Doctrine," a trust cannot be modified or terminated if doing so would frustrate a settlor's material purposes in establishing the trust. *See Claflin v. Claflin*, 20 N.E. 454, 456 (Mass. 1889).

The primary duties of a fiduciary are the duties of loyalty and prudence as well as the duty to administer the trust pursuant to its terms, reflecting settlor intent.

Modern trust law developments have weakened the Claflin doctrine in various respects. The Restatement (Third) of Trusts argues for a balancing test and permits a judicial modification of trusts if the court finds that the reasons for modification outweigh the material purposes of the trust. RESTATEMENT (THIRD) OF TRUSTS §65. The UTC permits nonjudicial and judicial modification of trusts in various circumstances (see Items 82-84 above), and §411(c) breaks from prior law by providing that a spendthrift provision is not presumed to constitute a material purpose. The "Benefit the Beneficiaries Rule" in §404 of the UTC provides that a trust and its terms must be for the benefit of his beneficiaries, and this is a mandatory provision that cannot be overridden. §404, §105(b)(3)(mandatory rule). State decanting laws permit a trustee to distribute assets to a new trust that may have dramatically different provisions (although the distributed provisions must be similar unless the trustee has wide discretion in making distributions).

Despite the trend toward liberalization of trust modifications, limitations still apply, designed to emphasize the importance of settlor intent. A Florida case in 2018 refused to terminate a trust early, contrary to the settlor's intent that the trust provide income to his son for life. The court reasoned: "In essence, the beneficiaries simply prefer a different course of action than that chosen by the settlor; they want their money now." That was not a good enough reason. *Horgan v. Cosden*, (Fla. Dist. Ct. May 25, 2018).

90. Limitations on Settlor Intent Have Always Applied

Certain limitations on settlor intent have always applied, including prohibitions against illegal acts, capricious purposes, or acts contrary to public policy. Prof. Langbein concludes that a settlor can individually burn his own Rembrandt, but cannot contribute a Rembrandt to a trust and direct the trustee to destroy it. *See* John H. Langbein, *Burn the Rembrandt? Trust Law's Limits on the Settlor's Power to Direct Investments*, 90 B.U. L. REV. 375 (2010). This concept is now embodied in the Benefit the Beneficiaries Rule §404 of the UTC.

91. Reasons for Trend to Allow More Flexibility to Adjust Trusts

Some of the reasons for the trend toward the relaxation of rules for modifying trusts include:

- Trusts are lasting longer (many states no longer follow the rule against perpetuities);
- Trusts are law no longer just for the wealthy but are common for middle classes;
- Modern trusts are more likely to last for the lifetimes of beneficiaries rather than being terminated as beneficiaries reach certain ages;
- Trusts are larger; they may be seeded with gifts but build much more rapidly with large sales to the trust;
- Tax laws affecting trusts frequently change;
- Trusts sometime reflect the draftsman intent more than the settlor's intent;
- Clients often don't even read trust instruments;
- Settlor intent may change over time (sometimes rather quickly);
- The material purpose of the trust may not be clear but just reflect a generalized anxiety and desire for a safety net for trust beneficiaries (indeed, clear and convincing extrinsic evidence may be used to show the trust's material purpose); and
- Public policy may change over time.

92. Intent Furthering vs. Intent Defeating Modifications

Planners who prefer to focus on settlor intent acknowledge that modifications designed to further settlor intent (for example, modifications needed because of changed circumstances) are not troubling. Over a long period of time, the case favoring settlor intent weakens.

93. Decanting Distinction

A key distinction between decanting and other types of modifications is that the essence of decanting is the exercise of a discretionary distribution power by the trustee. Nonjudicial modifications of trusts typically do not require joinder of the trustee, and the persons effecting the modification are not acting under fiduciary duties. That is drastically different than decanting, under which the trustee is subject to fiduciary duties with respect to the decision to decant and the structure of the new trust.

94. Drafting Recommendations

a. **Limiting Modifications**. If a settlor wants to require that certain actions be taken or not taken, the trust instrument must really lock down the proscription. Do not include any language that a beneficiary could point to in order to justify a modification.

   Precatory language may provide some guidance, but a court may respond "it's okay to wish there were an Easter bunny, but wishes are not legally enforceable." The difference between wishing and mandating is to decide what will actually be done.

   Consider including a material purpose clause to make clear what the settlor intends to accomplish with the trust (for example, is the trust a safety net for beneficiaries or the primary or sole source of income for them?). An informal audience poll suggests that relatively few in the audience include material purpose clauses in their trust agreements.

   The trustee or a trust administrator should review the material purpose clause and feel comfortable that it can be administered.

   In terrorem clauses might be triggered if a beneficiary participates in any effort to change a dispositive provision in the agreement. However, in an age of super-long-term trusts, such an interim clause may be dangerous and eventually frustrate changes that everyone might agree would be consistent with settlor intent based on changed circumstances.

   A good trust summary letter to the settlor may be very helpful in describing the intent of the trust agreement. Even if the letter is not admissible as evidence in a court proceeding, it may be very effective in helping the settlor's children to understand the overall purpose of the trust even though the settlor may not have read every word of the trust agreement.

b. **Encouraging Flexibility**. Providing wide discretion in distribution standards, giving beneficiaries limited powers of appointment, including settlor substitution powers, and giving trust protectors the ability to amend the trust for various specified reasons all allow significant flexibility without requiring any trust modification.

c. **Achieving a Balance**. Clary Redd provides excellent practical suggestions for striking a balance in planning trusts to meet the goals of particular clients:

   > Achieving an appropriate balance between flexibility and certainty in an estate plan is a delicate exercise and varies from one client to another. A client could consider including in his will or trust instrument a strong statement regarding his dispositive desires and his overriding wish that, notwithstanding what may be possible under applicable law, his dispositive plan not be disturbed, except in the most compelling of circumstances. Additionally, a client could include an explicit statement in his will or trust instrument regarding the client's "material purposes" (thereby making it

more difficult to change provisions that would implement such purposes). Yet another approach is to include "in terrorem" language in the will or trust instrument that would remove as a beneficiary anyone who initiated or participated in any process or proceeding to alter specified provisions or types of provisions. Still further, many decanting statutes can be used only if the trust's governing instrument doesn't provide otherwise, so a client who's concerned about the potential for decanting may be able to eliminate that potential by including a provision prohibiting decanting. Finally, although under UTC Section 105(b) a court would always have authority to modify or terminate a trust under UTC Sections 410 through 416 regardless of any provision in the governing instrument, a governing instrument could limit or prohibit using a nonjudicial settlement agreement under UTC Section 111 to modify a trust without court involvement or transferring the trust's principal place of administration to another state under UTC Section 108.

Whether any of the prophylactic provisions suggested above should be included in a client's estate-planning documents and, if so, specifically how they should be designed, is debatable. Moreover, given the wide variety of states' trust laws, whether or to what extent such provisions would be enforceable would have to be considered carefully on a case-by-case basis. What seems beyond debate, however, is that estate-planning clients deserve to know of the potential that their estate plans could be turned upside down and what the possible preventative remedies are.

Charles A. Redd, *Flexibility vs. Certainty—Has the Pendulum Swung Too Far?*, TRUSTS & ESTATES 6, 7-8 (March 2015).

Items 95-104 are observations from a seminar by Peter S. Gordon, Philip J. Hayes, and Susan D. Snyder, "It's Not My Fault! The Devil Made Me Do It." Fiduciary Liability Under the Uniform Directed Trust Act

95. Description and Background of Directed Trusts

a. **General Description**. A directed trust provides that certain powers or discretions traditionally held by the trustee will be vested in someone else who is not a trustee (referred to in the Act as a "trust director" and sometimes referred to as an adviser, as is the case in Delaware). An alternative is to provide that a fiduciary makes decisions with the consent of a director.

A variation is to divide the responsibilities and discretions of the trustees among separate co-trustees (sometimes referred to as bifurcated co-trustee powers).

Another variant is to provide for a "Trust Protector" who may have any of various powers for adapting to changing conditions. These may include powers: to amend the trust for administrative and tax purposes; to change the situs and governing law; to appoint, remove, and replace the trustee and other trust directors; to convert the trust from a grantor trust into a non-grantor trust for income tax purposes; and to expand the permissible class of beneficiaries.

The power or discretion can relate to investment decisions, management decisions, distribution decisions, and any other decisions affecting the administration of the trust. Common uses of an investment director are to authorize holding a concentrated position in the investment portfolio, to authorize someone to give directions regarding investment issues while the trustee is responsible for distribution decisions, or to authorize someone to direct investment issues as to particular holdings parenthesis (such as a family closely-held business). A distribution director may be used to give someone who is very familiar with the family and needs of family members the authority to direct distribution decisions. A distribution director may be used with beneficiaries that have special needs or substance abuse issues.

b. **Early History**. The directed trust concept is not new. The DuPont family has used the general directed trust concept in Delaware since the early 1900s; the early versions merely limited the trustee's power to sell specific trust assets without the consent or written direction of someone else. A Harvard Law Review article in the 1960s discussed the concept.

c. **Recognition in Modern Trust Law Authorities**. Section 808(b) of the Uniform Trust Code (UTC) authorizes the trust to confer upon a person other than the trustee the power to direct certain actions of the trustee. The trustee shall act in accordance with an exercise of the power "unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust."

   Section 75 of the Restatement (Third) of Trusts similarly authorizes the terms of a trust to confer a power to direct or otherwise control certain conduct of the trustee upon another, and the trustee has a duty to act in compliance with any exercise of that power "unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries."

   Several cases have recognized the authority granted to trust directors and the limited liability of trustees in following the directions given by trust directors. *E.g.*, *Duemler v. Wilmington Trust Co.*, C.A. No. 20033 N.C. (Del. Ch. 2004); *Rollins v. Branch Banking and Trust Company of Virginia*, 2001 WL 34037931 (Va. Cir. Ct.)

   Directed trusts have become increasingly popular, with various states now having adopted directed trustee statutes (including Delaware in 1986) and culminating with the promulgation of the Uniform Directed Trust Act in 2017.

d. **Summary of Uniform Directed Trust Act and Planning Issues for Directed Trusts**. For a summary of the Uniform Directed Trust Act as well as planning issues for directed trusts, see Item 9 of the Heckerling Musings 2019 and Other Current Developments found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

   Highlights of some of the major issues are summarized below. Unless otherwise apparent from the context, references in this section below to the "Act" and to "§"s are to the Uniform Directed Trust Act and to sections of that Act.

96. Fiduciary Duties of Trust Director; Submission to Jurisdiction

A trust director has the same fiduciary duties and liability as a trustee under like circumstances. §8 (a). Whatever duties a trustee would have had while holding that same power are also held by the trust director. The duties can be varied to the same extent that the duties of a trustee can be varied. §8(a)(2). For example, under most states laws, a fiduciary's duties cannot be reduced below a gross negligence standard.

The act specifically acknowledges the creation of springing powers, in which event the trust director will have no duties until the power is triggered. For example, "a settlor could grant a trust director a power to direct a distribution, but only if the director was requested to do so by a beneficiary. A director holding such a power would not be under a duty to act unless requested to do so by a beneficiary." §8(a)(1) cmt.

The act contains a provision granting jurisdiction over the trust director. By accepting the position as trust director, the director submits to personal jurisdiction of the courts of the state under which the Act is applicable to the trust with respect to any power or duty of the director. §15.

97. Fiduciary Duties of Directed Trustee

The most controversial issue addressed by the drafting committee, after "extensive deliberation and debate" (as described in the Comments to §9 of the Act), is the fiduciary obligation of the directed trustee.

a. **Willful Misconduct Standard for Whether to Follow Directions**. Three general regimes for the directed trustee's level of responsibility have been used.

(i) **Serious Breach of Fiduciary Duty**. The common law standard, as codified in §808(b) of the UTC, is that if a trust confers a power upon someone other than the settlor of a revocable trust to direct certain actions of the trustee, the trustee shall act in accordance with those directions "unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of fiduciary duty that the person holding the power owes to the beneficiaries of the trust." That standard has been very unpopular, and every state that has adopted a directed trust statute (other than states that adopted the full UTC) has done something different.

(ii) **Full Reliance**. Some states, such as Alaska, New Hampshire, Nevada, and South Dakota, have adopted a "no duty, full reliance" approach. Arkansas is considering a bill providing that the trustee has no liability for any loss from complying with directions from a director including any loss from the director's breach of fiduciary duties or the director acting beyond the director's scope of authority. The full reliance approach is what many settlors want—they want to specify that particular persons are responsible exclusively for specific fiduciary functions. They trust those persons to carry out those functions, and they do not want to pay other persons to oversee those functions. All basic trust functions are subject to fiduciary duties, but are not subject to "cross fiduciary duties." It is a "why can't I say what I want?" approach.

(iii) **Willful Misconduct**. The third option is a much reduced fiduciary obligation approach, such as a willful misconduct standard that is used in the Delaware statute (as well as in Illinois, Texas, and Virginia).

The Act follows the Delaware "willful misconduct" approach. The directed trustee is not liable for taking "reasonable action to comply with a trust director's exercise or nonexercise of a power of the direction," except that "a directed trustee must not comply with a trust director's exercise or nonexercise of a power of direction… to the extent that by complying the trustee would engage in willful misconduct." §9(a)-(b).

The committee adopted the willful misconduct standard approach rather than the complete abolition of duty approach for several reasons, expressed in the Comments to §9 of the Act. (i) The willful misconduct approach "is more consistent with traditional fiduciary policy," preserving a minimum of duty for a trustee to maintain the traditional notion that a trustee is a fiduciary. (ii) The directed trust statute in Delaware with its willful misconduct standard has been popular and "establishes that a directed trust regime that preserves a willful misconduct safeguard is workable and that a total elimination of duty in a directed trustee is unnecessary to satisfy the needs of a directed trust practice." (iii) The willful misconduct approach may be even more protective than the "no duty" approach if a court were to hold that an implied duty of good faith always exists if a fiduciary duty is not otherwise present.

b. **Determining Whether Director Is Acting Within Scope of Authority**. A slightly different issue than the standard for fiduciary responsibility with respect to following the directions of a director is the threshold duty that the trustee abide by the terms of the trust instrument and determine that the director is acting within the scope of authority granted to the director under the trust instrument.

c. **Reasonableness Standard for Implementing Direction**. The directed trustee must take reasonable actions to comply and implement the direction. §9(a). **Whether** to implement the direction is subject to a willful misconduct standard, but if the direction does not fail the willful misconduct standard, a reasonableness standard applies in **how** the direction is executed.

98. Determining Appropriate Directed Trustee Compensation

Being a directed trustee is not a "no liability" proposition and the directed trustee's compensation should be set appropriately. Federal bank regulators are critical of directed trusts by national banks, because they believe they are much riskier than reflected by the typical trustee fee being paid for serving as a directed trustee.

One of the first court cases addressing fees for a directed trustee is *Estate of Zeid*, 2017 IL App (1st) 162463-U (2017), in which the trustee negotiated a flat fee rate of 65 basis points annually, but waived its "miscellaneous, litigation, and closely held asset fees." The bank-trustee requested information about directed assets (at the request of the surviving spouse so she could decide whether to exercise her rights over the marital trust to compel actions regarding assets that were not productive of income), which the director (a son from a prior marriage) refused to provide. The bank became concerned over the director's restructuring of debt between different entities that were part of the special directed assets. The director sued the bank to impose a different fee structure and force disgorgement of fees previously taken. The court upheld the negotiated fee as reasonable, pointing to the fact that the directed trustee still had numerous obligations.

99. Ability to Seek Court Approval

The Act specifically authorizes a directed trustee "that has a reasonable doubt about its duty" under the Act to "petition the [court] for instructions." §9(d).

100. Case Studies-Specific Directed Trust Situations

Interestingly, the drafting committee chose not to provide any guidance as to what constitutes "willful misconduct," and very little case law exists as to what constitutes willful misconduct. The panel addressed a variety of case studies, and the primary issue that arose repeatedly is whether the trustee's compliance with the direction in that situation would constitute "willful misconduct."

a. **Investment Concentrations**. This is by far the most widely used directed trust situation. The settlor wants to maintain a concentrated investment position and appoints a trust director with responsibility over that particular investment (or perhaps all investments). "If willful misconduct means something different than ordinary negligence, relying on a direction about investment concentrations must be ok." But situations could exist raising concerns. For example, what if the trust director is the chairman of the board of a company that is struggling mightily, or what if the trustee's investment department has a strong sell order on the particular stock?

b. **Conflicting Directions**. Multiple trust directors may have conflicting views and give conflicting directions to the directed trustee. A petition to the court for instructions or a trustee resignation may be the only alternatives for the directed trustee.

c. **Family Business, Director with Conflict of Interest.** A very common situation is for a settlor to name one child as the trust director with respect to a family business owned by the trust. What if trusts for a son and daughter each own 50% of the family business, and the son as trust director directs the trustee to sell one share from the sister's trust to the son's trust shortly before the sister's trust terminates, leaving the sister's trust with a minority interest? The trustee would know that this direction benefits the son to the detriment of the sister. Does that reach the level of willful misconduct? The trustee in this situation should disclose the sale direction to the sister, consider obtaining a release from her, and document that communication. This type of situation highlights the directed trustee's residual responsibility. Although this type of situation involving a family business is common, planners should anticipate that conflicts eventually may arise.

d. **Opaque Investment Holdings**. The trust director may direct the trustee to transfer substantial trust assets to a 100% owned LLC, with the director as the manager of the LLC. What if the trustee gets no information about investments within the LLC? Could the director be engaging in transactions unreasonably benefiting himself (such as receiving distributions, loans, or unreasonable compensation)? The LLC may be making distributions to others who are not trust beneficiaries (i.e., charitable contributions). On the one hand, investing trust assets in an LLC managed by the director is just a method of implementing director control of the investments. The more difficult issue is if the LLC becomes a "black box" to the trust.

e. **LLC as Trust Director**. In some circumstances LLCs have been named as trust directors. That seems to be permitted because any "person" can be a director and under the uniform laws a "person" includes entities. This may skirt local laws that generally restrict entities from serving as a trustee unless they comply with trust company regulatory requirements.

f. **Conflict of Interest**. Assume a scenario in which one co-trustee (C1) has the exclusive power over the investment of trust property, and C1 directs investment of the bulk of the trust property in a series of fledgling technology startup companies in which C1 is an investor or a member of the Board of Directors or for which C1 provides consulting services. The other co-trustee (C2) is aware of the conflict of interest, that C1 has not undertaken due diligence to support the investments, and that the investments are not prudent in light of the beneficiary's limited risk tolerance. That scenario may present a willful misconduct situation, and a petition for court instructions would be appropriate.

g. **Litigation**. Unless the trust agreement provides otherwise, a trust director "may exercise any further power appropriate to the exercise or nonexercise of a power of direction granted to the director." §6(b)(1). This is a type of "necessary and proper" clause, granting additional implied powers as appropriate to carry out a settlor's intent (such as the power to incur reasonable costs, provide accountings, employ advisors, bring litigation to enforce the powers, etc.).

A director probably has the authority under this provision to direct the trustee to sue or to bring a lawsuit directly to enforce some action within the director's scope of responsibility (for example, with respect to a particular investment). Indeed, the director has all the duties of trustees in similar situations; a trustee would have a duty to bring a claim to enforce rights as long as it is cost efficient (UTC §811), so a director arguably has not only a power but a duty to bring a lawsuit to enforce claims. Bringing a lawsuit in the name of the trustee (the trust itself is not a legal entity) seems rather odd, but is authorized. The trustee may, for various reasons be delighted not to be directly involved in and controlling the litigation.

101. Information Sharing; No Cross Monitoring Required

a. **Information Sharing**. The trust director and directed trustee must communicate with each other. For example, a director with a power to amend would have to inform the trustee of any amendment. A trustee responsible for investments must know what cash distributions will be needed for distributions directed by a trust director.

All trust directors have a duty to give information to directed trustees reasonably related to the powers or duties of the trustee, and vice versa. A trust director "shall provide information to a trustee or another trust director to the extent the information is reasonably related both to: (1) the powers or duties of the director; and (2) the powers or duties of the trustee or other director." §10(a). Section 10(b) imposes a similar duty on a directed trustee to share information with a trust director. These duties include both an affirmative duty to provide information (even if it is not requested) and a responsive duty to reply to requests for information.

A safe harbor is provided for trust directors and trustees who act in reliance on information provided to them as long as the person relying on the information is not engaged in willful misconduct. §10(c)-(d).

The information sharing requirement in the Act applies only between trust directors and directed trustees, and does not extend to beneficiaries. The duty to provide information to beneficiaries is governed by the general trust fiduciary law in the enacting state. Even though the trustee may not be required to report the director's directions before implementing the direction, the trustee may still have a duty to report the transactions in its normal accounting reports for the trust.

b. **Cross Monitoring**. A concern raised by the requirement to share information is whether, upon receiving information, a duty would arise to advise anyone else (beneficiaries, other trustees or directors) that the person would have made a different decision. The Act specifically provides that "a trustee does not have a duty to… monitor a trust director… or… inform or give advice to a similar, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director." §11(a). Section 11(b) provides mirror monitoring relief for a trust director as to the monitoring conduct of a trustee or other trust director.

102. Bifurcated Co-Trustee Responsibilities

The traditional trust law rule is that co-trustees must use reasonable care to prevent a co-trustee from committing a breach of trust, even if the settlor limits the role or function of one of the co-trustees. The Act incorporates all of the provisions regarding trust directors and directed trustees for co-trustee arrangements in which co-trustees are assigned specific responsibilities. "The terms of a trust may relieve a co-trustee from duty and liability with respect to another co-trustee's exercise or nonexercise of a power of the other co-trustee to the same extent that in a directed trust a directed trustee is relieved from duty and liability with respect to a trust director's power of direction under Sections 9 through 11." §12.

Accordingly, a settlor could assign specific responsibilities to separate co-trustees, and the reasonable action and willful misconduct standards described in the Act would apply with respect to a co-trustee's exercise or nonexercise of a power of the other co-trustee. The rules regarding information sharing and cross-monitoring would also apply to bifurcated co-trustee responsibilities.

Whether a particular trust agreement adopts the divided co-trustee responsibilities is a matter of construction. The traditional law of co-trusteeship would apply as the default rule, but the terms of the trust can manifest a contrary intent. §12. For example, if the decision of one co-trustee controls over that of another in the event of a disagreement, or if a trust gives one co-trustee investment powers with respect to certain trust property, the protections under the Act would appear to apply. The controlling trustee as to a particular function would be treated like a trust director, and the non-controlling trustee would be treated like a directed trustee.

103. Forms

The written materials contain forms for trust provisions appointing an investment direction director, distribution director, special holdings direction director, trust protector, and exclusive duties of a trustee. In addition, a sample distribution director direction letter is included.

104. Drafting Tip for Age-Based Distributions

If the settlor has any concerns about beneficiaries learning of the existence of the trust before an appropriate age, do not provide for distributions to multiple beneficiaries as each reaches a certain age, or else younger beneficiaries will learn about the trust when the older beneficiaries receive distributions as they reach those ages. Provide for age-based distributions when the youngest beneficiary reaches the designated ages.