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TRUST AND ESTATE ATTORNEYS

Trust Modifications

1. Modifications, Generally

A.1 Overview. A trust is like a contract, and its terms can usually be modified only as provided in the trust instrument or as permitted by law. Well-prepared trust instruments will specify, at least to some degree, what changes can be made and how. Ideally, a trust should specify what cannot be changed or specific types or methods of changes that are prohibited.

A.2 Types of Changes. There are several changes that may be desired. The settlor, the trustee, and the beneficiaries may have different reasons for wanting a change (or wanting to prevent a change). The changes that are often desired include:

(a) Changing the trustee or successor trustee;

(b) Changing or adding advisors, such as an investment advisor or "trust protector;"

(c) Adding or removing beneficiaries;

(d) Changing the assets or share allocated to beneficiaries or the timing and nature of distributions to beneficiaries;

(e) Changing applicable law or the trust situs; and/or

(f) Adding administrative provisions that can affect a beneficiary's share, such as a no-contest clause, a provision requiring a property agreement with a spouse or significant other, a clause allowing the trustee to require drug testing of beneficiaries, a provision allowing the trustee to delay a distribution to a beneficiary who is under threat of a lawsuit, who is in bankruptcy, or going through a divorce, etc.

A.3 Modifications Allowed. What changes can be made to a trust depend on the type of trust, the language of the trust instrument, and the laws of the state that govern the trust.

(a) The trust instrument is the first place to look for a power to make a change, but if the trust does not contain specific language allowing a change, it is possible that the governing law will permit the change. The trust instrument should specify the person or persons who have the power to make specific changes. For example, some trusts allow the settlor to make some changes, the trustee to make other changes, and other designated advisors to make even more changes.

(b) The laws applicable to trusts permits some changes to be made, but trust law is not the only law that needs to be considered. For example, some desired changes will affect the income-tax, gift-tax, estate-tax, or generation-skipping-tax consequences of the trust. For another example, if a trustee modifies a trust in a way that reduces intended benefits for a beneficiary or group of beneficiaries may be breaching the trustee's fiduciary duty even if the change being made is otherwise permitted by law. Avoiding unintended consequences should be a key element in deciding what changes are appropriate to make.

A.4 Types of Trusts. A testamentary trust is created as part of a last will and testament. A "living trust" (also known as an "*inter vivos* trust" or a "nontestamentary trust") is created under a written document that is usually called a "trust agreement" or under a "declaration of trust." For the purposes of this memo, the term "trust instrument" will be used to refer to any of the above.

A.5 Revocable or Irrevocable. Most living trusts are revocable because the trust instrument contains a provision that expressly allows the settlor to amend or revoke the trust. A trust that is revocable can be freely changed by the person having the power to amend or revoke. When the last person having a power to amend or revoke dies, the trust becomes irrevocable. For that reason, a testamentary trust cannot be revoked by the settlor because it does not come into effect until the settlor is deceased. Under Nevada law, a trust is irrevocable by the settlor unless there is a provision in the trust instrument that says otherwise, and the changes that can be made to an irrevocable trust can be very limited.

B. METHODS OF CHANGE

B.1 Amendment. The easiest method to make a change is to amend the trust to the extent allowed by the trust instrument. Irrevocable trusts cannot usually be amended; however, some irrevocable trusts permit administrative amendments, which do not change beneficiaries but simply change some of the trust's administrative provisions.

(a) The simplest amendment simply modifies or replaces a few provisions of the trust, and the trustee is required to refer to both the original trust instrument and the amendment.

(b) If the changes to the trust are significant, it is often better to amend the trust by completely replacing the original trust agreement. This is done by "restating" the trust. A trust restatement is sometimes called an "*in toto* amendment" because it replaces the trust instrument "in total." Sometimes a restatement is more cost effective because patching up an old trust can require significantly more work because of the need to incorporate changes into an existing document that has different terms and a different structure. Even if it is more costly, a restatement can update antiquated provisions and eliminate the confusion of having multiple documents to refer to.

(c) Some people prepare multiple amendments to their documents, but the more amendments that are in effect, the more confusing the document becomes. The better practice is to have the latest amendment replace all prior amendments so that there are, at the most, only two documents (e.g., the current amendment and the original trust or the most recent restatement) that a trustee and the trust beneficiaries need to refer to.

B.2 Power to Change Trustees. If the trust instrument of an irrevocable trust gives the settlor or someone else the power to change trustees, that power can be exercised without amending the provisions of the trust.

B.3 Power of Appointment. In addition, an irrevocable trust may provide for one or more persons to have the power to change beneficiaries. This called a "power of appointment."

(a) Sometimes a power of appointment can allow someone to change the beneficiaries of a trust (or of a specific share of a trust) that is effective while person holding the power is living. This is an "*inter vivos* ""or lifetime power of appointment." A trust for the benefit of a settlor's spouse may, for example, give the spouse the power to appoint part of a trust to posterity and/or to charitable organizations.

(b) Sometimes a power of appointment can only become effective after the power holder's death. This is called a "testamentary power of appointment." It is often exercisable under the power holder's last will and testament, but it is common to provide that it can be done in another written instrument as well. It is common, for example, for a trust for the benefit of a settlor's child to allow the child to specify the beneficiary or beneficiaries of the child's share after the child's death.

(c) A power of appointment may allow the power holder to specify any beneficiaries or it may be restricted to a limited group of potential beneficiaries.

B.4 Judicial Reformation. It is well recognized that a court having jurisdiction over a trust can reform the trust instrument to correct errors (e.g. scrivener's error) or make changes when justified by a material change in circumstances.

(a) The court can correct errors if the provisions do not reflect the settlor's intent or when the settlor's intent was founded on a mistake. If a provision is archaic or inapplicable under the current situations, a reformation may be appropriate.

(i) For example, when the language of a trust instrument is poorly written so that the intended tax objectives are not achieved (such as qualifying for a marital or charitable deduction), the trust can be reformed by the court so that those objectives are met.

(ii) The IRS is not generally bound by a state court ruling, but the IRS will respect a reformation if it is done timely and in such a way that is not intended to circumvent applicable tax law.

(b) The courts are generally reluctant to approval a reformation just because the beneficiaries are unhappy with the trust's original provisions. Decanting or a nonjudicial settlement agreement may be better suited for that type of trust modification.

B.5 Decanting. In recent years, many states, including Nevada, allow a trustee who has discretion to make distributions to various beneficiaries to create and transfer assets to a second trust with somewhat different terms. The process of "pouring" assets from the original trust to a second trust is referred to as "decanting", but that term is not used in the applicable Nevada statute.[1] Although anyone can be the settlor of the second trust, the decanting of assets into the second trust must be done by the trustee and is a viable option only if the trustee is willing to do it.

(a) Decanting is sometimes used to split a trust for different persons into separate trusts, and it is sometimes used to replace the original trust entirely. If the trustee has the power to make unequal distributions to the exclusion of one or more beneficiaries, the second trust can exclude one or more beneficiaries.

(b) The power to "decant" is part of a trustee's discretion and does not require approval by the trust's beneficiaries or by a court, but the law permits the trustee to seek either. Nevada law does not specifically require that the trustee notify the beneficiaries in advance of the decanting, but, at a minimum, the trustee's duty to keep beneficiaries reasonably informed probably requires that the beneficiaries be informed after the fact.

(c) Decanting may not be appropriate to accomplish some objectives. The key rule is that a decanting cannot deprive a beneficiary of a legally enforceable right. The transactions that are expressly prohibited by statute include:

(i) Nullifying an income interest or benefit that is needed for tax benefits, such as a charitable deduction, marital deduction, or a trust that qualifies for benefits under a specific tax-code provision; or

(ii) Depriving a beneficiary of the benefit of specifically allocated property without the beneficiary's consent.

(d) The second trust cannot contain any additional beneficiary, but the trustee can give a power of appointment that allows a trust beneficiary to add one or more beneficiaries.

[1] NRS 163.556 is Nevada's decanting statute.

(e) The Internal Revenue Service (IRS) is not bound by state law, and there can be unintended tax consequences if the decanting is done without keeping tax laws in mind. Consider these examples:

(i) Nevada law permits decanting a nongrantor trust into a grantor trust and vice versa; however, the IRS will not issue rulings on whether that change will be recognized.

(ii) If a beneficiary consents to or acquiesces in a decanting that the IRS believes reduces that beneficiary's enforceable rights, the IRS may assert that a gift from the beneficiary has been triggered. Where there is a dispute among beneficiaries, a nonjudicial settlement agreement may be the more appropriate vehicle.[2]

[2] The compromise of a dispute under a settlement agreement does not generally trigger taxable gifts, but the IRS has refused to apply that rule if the dispute is not a "bona fide" dispute.

B.6 Nonjudicial Settlement Agreement. Many states, including Nevada, allow the beneficiaries to agree on a reformation of the trust without having to go to court. Nevada law permits a "nonjudicial settlement agreement" to modify a trust.[3] This is typically used to resolve a dispute between or among beneficiaries and/or trustees, but some are using it in lieu of decanting when the trustee has declined to decant or when it is thought that a decanting without the beneficiaries' consent may be more susceptible to challenge by the beneficiaries than a nonjudicial settlement agreement.

B.7 Non-Nevada Trusts. Any modification to the trust must be done under the laws that govern the trust. Thus, Nevada law will not apply to a trust that is governed under the laws of another jurisdiction. If a trustee or beneficiaries desire to modify a trust under Nevada law, steps must be taken to make the trust one that is governed under Nevada law.

(a) Some trusts permit the trustee or another advisor (such as a trust protector) to change the governing law, and some do not. Some trusts permit the trustee or another advisor to change the "situs" or legal domicile of the trust.

(b) If the trust instrument is silent as to the governing law, the general rule is that the laws of the "situs" state will apply, and in most situations, the situs of a trust is determined by the domicile of the trustee unless a specific situs is declared. Thus, the situs can sometimes be changed by having an individual, bank, or trust company that is domiciled in Nevada serve as the trustee (or at least as a co-trustee).

(c) If the trust is not governed under Nevada law, it makes no sense to use Nevada law to attempt to modify the trust.

C. CONCLUSION

C.1 Read the Trust Instrument. The first step in modifying a trust is to read the trust instrument and to see what that documents permits to be changed and who has the power to make the desired changes.

C.2 Get Legal and Tax Advice. Before making a change, it is best to seek legal counsel to make sure the changes you want are allowed and advisable from a state-law perspective, from a fiduciary-duty perspective, and from a tax-law perspective. Sometimes changes made to trusts have triggered unanticipated consequences that could have been avoided with sound legal advice. If tax issues are potentially involved, consulting with a certified public accountant or other qualified tax advisor is recommended.

***Note:* This memo is made available by Lee Kiefer & Park, LLP for educational purposes only as well as to provide a general understanding of the law, not to provide specific legal advice. You should contact an attorney to obtain advice with respect to any particular issue or**

[3] Nonjudicial settlement agreements are governed under NRS 164.940 et seq.

problem.