

Modifying Irrevocable Trusts



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Only one thing in life is certain – change. People change, tax laws change, and the world changes. After a certain amount of time, every irrevocable trust will fail to meet the exact needs of the beneficiaries. At some point, a trustee, a beneficiary, or the settlor of the trust may feel that some aspect of an irrevocable trust should be changed.

The reasons to change an irrevocable trust are limitless. At the extreme, the settlor may want to remove or add a beneficiary or a class of beneficiaries. Or the beneficiaries may want to terminate the trust early due to an immediate need (or want) for the money. At the other end of the spectrum, there may be administrative provisions of the trust that just need to be tweaked. For example, a bank may want to see specific language in the trust before allowing the trust to take out a loan or secure a loan.

The majority of changes lie somewhere in the middle. The identity of the successor – or current - trustee may need to be altered. A trust may provide the beneficiary with a right of withdrawal or require the trust assets to be distributed outright to the beneficiary at a certain age. To increase the asset protection, divorce protection, or estate tax benefits of the trust, the rights of withdrawal or mandatory payouts may need to be removed. If the trust beneficiaries no longer get along, the trust may need to be divided into multiple trusts for separate beneficiaries.

The trust instrument itself may



allow the change through the existing powers of the trustee, a trust protector, the exercise of a beneficiary's power of appointment, or through a retained power in the settlor. But only so much flexibility can be built into the trust instrument itself. When the trust does not allow for an intended change, then state law may provide the answer.

Missouri has some of the most flexible laws when it comes to changing irrevocable trusts. A number of different statutes in Missouri allow irrevocable trusts to be changed with court approval by:

- Showing circumstances not anticipated by the settlor,
- Showing the trust assets are insufficient to justify the cost of administration,
- “Reforming” the trust to conform to the settlor’s intentions,
- Modifying the trust to achieve the settlor’s tax objectives, or
- Removing the current trustee.

In addition, the broadest statute allows a trust to be changed if all of the adult beneficiaries consent and the court finds that the interests of the nonconsenting beneficiaries will be adequately protected.

In many circumstances, court approval is not necessary. You may change a trust without going to court in each of following ways:

- Altering the administrative provisions if all of the interested parties consent,
- Transferring the trust assets to another trust (decanting),

- Merging the trust with another trust,
- Providing a trustee or trust protector with the ability to change the trust,
- A beneficiary disclaiming/renouncing an interest in the trust,
- The trustee converting trust principal to income or income to principal, or
- The trustee converting an all income trust to a “unitrust.”

In addition, the broadest nonjudicial statute allows a trust to be changed if the settlor and all of the adult beneficiaries consent.

Sometimes the challenge is not finding a way to change the trust, but changing the trust in a way that does not have adverse tax consequences. By changing the terms of the trust you may accidentally cause adverse gift, income, estate, or generation-skipping transfer (GST) tax consequences. For example, if a current beneficiary consents to a change that reduces the value of the beneficiary's interest in the trust, then that current beneficiary may be making a gift to the remainder beneficiary. Making a change to a trust that was irrevocable on September 25, 1985 may cause a loss of the GST exempt status of the trust. An income tax issue to be aware of is that the IRS takes the position that terminating a trust early by paying the current beneficiary the value of his/her interest in the trust is really a sale that triggers gain.

If you are a party to a trust that needs a change, then be sure to consider not only how to make the change, but how to make the change without causing adverse tax consequences.