IRREVOCABLE(ISH): CHANGING AN "UNCHANGEABLE" TRUST

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I. INTRODUCTION

A. The word "irrevocable" does not always mean what it seems.

1. "Irrevocable" means the grantor cannot revoke the trust. It does not mean the trust can never be changed.

2. Countless irrevocable trusts were created under tax laws and other circumstances that have changed. The families who created these trusts, and the CPAs, financial planners, and attorneys who advise them, need to understand the options.

3. Grantors create irrevocable trusts for many reasons, including removing assets from the taxable estate, protecting assets from creditors and divorcing spouses, providing for beneficiaries who cannot manage money or who have special needs, qualifying for public benefits, and controlling the ultimate disposition of assets (e.g., in a blended family).

B. Themes.

1. High federal gift and estate tax exemptions have made many irrevocable trusts unnecessary.

2. Even where the trust is needed, changed circumstances can make its terms unsuitable, and the goal is often to fix the trust rather than end it.

3. The trust agreement itself may contain built-in tools for change, such as trust protector provisions, trustee appointer provisions, powers of appointment, trustee powers, and amendment clauses.

4. Michigan law provides statutory relief when the trust document falls short, including reformation, modification, and decanting.

C. Why this matters to CPAs and financial planners.

1. You are often the first professionals to spot these issues, as you see the trust income tax returns, the compressed brackets, the unrealized gains, and the ongoing administration costs.

2. Know the landscape to help guide your clients.

II. HIGH EXEMPTIONS RENDER MANY IRREVOCABLE TRUSTS UNNECESSARY

A. The exemption explosion.

1. Selected history of the federal estate and gift tax exemption:

a. $600,000 (1997).

b. $1,000,000 (2002).

c. $2,000,000 (2006).

d. $3,500,000 (2009).

e. $5,000,000 (2011).

f. $11,180,000 (2018).

g. $13,990,000 (2025).

h. $15,000,000 (2026).

2. The One Big Beautiful Bill Act made the increased exemption permanent (i.e., there is no “sunset”).

3. The exemption will be adjusted for inflation after 2026.

4. The exemption is "unified," meaning the same $15,000,000 covers both lifetime gifts and the estate at death.

5. The generation-skipping transfer (GST) tax exemption is also $15,000,000 per person for 2026 and is permanent.

6. For many irrevocable trusts that were created when exemptions were a fraction of today's amount, the original tax-avoidance purpose is gone, but the trusts are still around.

B. The income tax cost of maintaining the trust.

1. Trusts and estates are subject to highly compressed federal income tax brackets:

   a. $0 – $3,300: 10%.

   b. $3,301 – $11,700: 24%.

   c. $11,701 – $16,000: 35%.

   d. Over $16,000: 37%.

2. A single individual does not reach the 37% bracket until $640,600 of taxable income. A trust reaches it at $16,000.

3. The Net Investment Income Tax (NIIT) threshold for a single individual is $200,000, but only $16,000 for a trust.

4. For a trust that no longer serves an estate tax purpose, there may be an ongoing income tax drag, unless the beneficiary is in the highest marginal bracket (in which case the "run up the brackets" is only of limited benefit anyway).

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5. Income of a "grantor trust" is taxed to the grantor, rather than the trust itself, even if distributions are made to a beneficiary.

C. Loss of stepped-up basis.

1. Assets in a decedent's estate generally receive a stepped-up basis. "Step up" can be a misnomer, as basis becomes fair market value at date of death (this may be higher or lower than basis immediately before death).

2. Assets held in an irrevocable trust generally do not receive a stepped-up basis at the grantor's death, and unrealized capital gains can be significant.

D. Common trust types affected.

1. "Credit Shelter," "Bypass," or "Family" Trusts.

a. Created at the first spouse's death under older estate plans to use the deceased spouse's exemption when exemptions were low.

b. Now the exemption is $15,000,000 per person and portable between spouses (provided an election is made on a timely filed estate tax return after the passing of the first spouse). This structure may be unnecessary.

c. Assets in the bypass trust do not receive a second step-up in basis at the surviving spouse's death.

d. The surviving spouse may have limited access to trust principal.

e. Many of these issues can be avoided if the funding formula provides for all assets to pass to the "Marital Trust" at death.

2. Irrevocable life insurance trusts (ILITs).

a. Created to keep life insurance proceeds out of the taxable estate.

b. With a $15,000,000 exemption, most families do not need this protection.

c. ILITs still require ongoing administration, such as Crummey notices, premium payments, etc.

3. Dynasty trusts may be an exception, as they generally are used by wealthy families that remain subject to estate tax.

III. CHANGED CIRCUMSTANCES: FIXING A TRUST WITHOUT TERMINATING IT

A. The trust is still needed, but some of its terms are no longer appropriate.

1. Often the goal is not to terminate the trust, but to keep its benefits (e.g., estate exclusion, creditor protection, GST-exempt status).

2. However, the client may want to fix specific problems.

B. Common examples:

1. The client wants a different succession of trustees (e.g., named successors have died, are unwilling or unsuitable, or are in conflict with the family, or a corporate trustee has merged or raised its fees).

2. A beneficiary is going through a divorce or has other creditor problems.

3. A beneficiary is a spendthrift or struggles with addiction, and outright distributions (e.g., one-third at 25, 30, and 35) could cause harm.

4. A beneficiary has become disabled, and supplemental needs provisions are needed to preserve eligibility for public benefits.

5. Tax provisions are less than ideal (e.g., no ability to cause estate inclusion to obtain a basis step-up, no ability to turn off grantor trust status, or mandatory income distributions).

6. Administrative provisions are outdated (e.g., investment restrictions, situs, governing law, or authority to hold closely held business interests or digital assets).

IV. READ THE TRUST AGREEMENT!

A. Why start here?

1. Many of the best available options will be found in the trust agreement.

2. Do not assume anything about the contents of the trust agreement. Read it. Then read it again.

3. Helpful provisions are often buried in “boilerplate.”

B. Amendment, modification, or termination provisions.

1. Some trust agreements give the trustee or another party broad authority to make changes under specified circumstances.

2. Provisions triggered by changes in tax law are common.

3. Provisions allowing a trustee to correct errors or interpret trust language.

4. Provisions allowing the trust to terminate when the trust estate falls below a certain value.

C. Provisions to change trustees.

1. The grantor of the trust or others may have the right to remove a trustee and appoint a successor trustee (sometimes called a “trustee appointer”).

2. Interested persons can agree to appoint a trustee under MCL 700.7111 (discussed below).

D. Trust protector provisions.

1. Many modern trusts include a "trust protector," who is generally an independent third party with specific powers (sometimes "superpowers") over the trust.

2. Trust protector powers may include authority to:

   a. Modify or amend trust terms, including distribution provisions.

   b. Change situs or governing law.

   c. Add or remove beneficiaries.

   d. Grant or modify powers of appointment.

   e. Amend administrative provisions.

   f. Remove and replace trustees.

   g. Terminate the trust.

3. The scope of the trust protector's power depends entirely on the language of the document.

4. A trust protector with the power to "modify" the trust may be able to address many of the problems caused by changed tax law without going to court.

5. You need to be careful that the trust protector's exercise of power does not create adverse tax consequences (e.g., gift tax, estate inclusion, or loss of GST exemption).

E. Powers of appointment.

1. Parties, including beneficiaries, are often granted powers of appointment.

2. The two categories are general powers of appointment and special (limited) powers of appointment.

3. A general power can be exercised in favor of the powerholder. A special power is anything other than a general power and can be as limited or broad as the grantor desires (e.g., the powerholder can appoint only in favor of the grantor's descendants versus in favor of anyone on the planet).

4. A broad power of appointment may allow a beneficiary or other powerholder to redirect trust assets or restructure beneficial interests.

5. Powers of appointment can sometimes be used to appoint trust property into a new trust with updated terms, effectively a private decanting.

V. MICHIGAN LAW MAY HELP

A. What if the trust agreement provides no solution? Michigan law provides solutions, but they are somewhat limited.

B. Non-judicial settlement agreement (NJSA) under MCL 700.7111.

1. Interested persons may enter into binding non-judicial settlement agreements with respect to matters involving a trust.

2. NJSAs can address the interpretation or construction of trust terms, approval of accountings, direction of a trustee, trustee resignation, appointment, or compensation, transfer of principal place of administration, and trustee liability.

3. CRITICAL LIMITATION: An NJSA "shall not be used to accomplish the termination or modification of the trust."

4. An NJSA is valid only to the extent it does not violate a material purpose of the trust.

5. Court approval is not required, but any interested person may request that the court approve the agreement.

C. Modification or termination under MCL 700.7411.

1. A noncharitable irrevocable trust may be modified or terminated in three ways:

   a. By the court, on consent of the trustee and all qualified trust beneficiaries, if the court concludes that the modification or termination is consistent with the material purposes of the trust.

   b. On consent of the qualified trust beneficiaries and a person or committee given the power to grant, veto, or withhold approval of proposed modifications.

   c. By a trustee or other person or committee given the power to direct modification or termination.

2. The second and third options require specific language in the trust agreement, so absent those special provisions, you must get approval of the court.

3. If the trustee refuses to consent or fewer than all qualified trust beneficiaries consent, the court can still approve if: (a) the trust could have been modified if all had consented, and (b) no non-consenting beneficiary's interest will be substantially impaired.

4. Applies only to irrevocable trusts created, or revocable trusts becoming irrevocable, after April 1, 2010.

D. Judicial modification for unanticipated circumstances under MCL 700.7412.

1. The court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable, wasteful, or impair the trust's administration.

2. The court may modify the administrative or dispositive terms of a trust, or terminate the trust, if, because of circumstances not anticipated by the grantor, modification or termination will further the purposes of the trust or the probable intention of the grantor.

E. Modification to achieve grantor's tax objectives under MCL 700.7416.

1. The court may modify the terms of a trust in a manner not contrary to the grantor's probable intention to achieve the grantor's tax objectives.

2. The modification may have retroactive effect.

3. Taxing authorities may not respect a retroactive modification.

F. Reformation to correct mistakes under MCL 700.7415.

1. The court may reform the terms of a trust, even if unambiguous, to conform the terms to the grantor's intention.

2. It must be proved by clear and convincing evidence that both the grantor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement.

G. Trust decanting.

1. Administrative decanting under MCL 700.7820a.

a. If an irrevocable trust includes a "discretionary trust provision" (as defined in MCL 700.7103(d)), the trustee may distribute trust assets to a second trust.

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b. Permits changes to administrative provisions, such as the succession of trustees, investment powers, accountings, situs, and governing law.

c. Beneficial interests CANNOT be materially changed.

d. Terms of the second trust cannot be inconsistent with the tax planning of the first trust.

e. The transfer to the second trust cannot: (i) increase trustee compensation, (ii) result in the charging of a fee without beneficiary consent, (iii) reduce the trustee's standard of care, or (iv) reduce the authority of a person who can direct or remove the trustee.

f. Extending the maximum vesting period is not a material change.

g. No court approval or beneficiary consent is required, but 63 days' notice to qualified trust beneficiaries is required.

h. Cannot decant if the trust expressly prohibits it.

2. Dispositive decanting under MCL 556.115a.

a. This statute is much broader than administrative decanting under MCL 700.7820a.

b. A trustee with a presently exercisable discretionary power to distribute income or principal may appoint trust property to a second trust.

c. The trustee's power must not be limited by a "definite and ascertainable standard." However, instructions to consider "best interests, welfare, comfort, happiness, or general development" do not constitute ascertainable standards.

d. Beneficiaries of the second trust need only include permissible appointees (even fewer than all). This may enable the trustee to narrow the class of beneficiaries.

e. Cannot reduce a presently exercisable general withdrawal power (protects Crummey and so-called 5 by 5 rights).

f. The second trust may provide powers of appointment to persons not beneficiaries of the first trust.

g. No court approval or beneficiary consent is required.

h. The legislature intended this as a codification of common law.

i. Cannot decant if the trust expressly prohibits it.

3. Cautions and risks with decanting.

a. Uncertain income tax consequences.

b. Uncertain gift and estate tax consequences when beneficial interests change.

c. Trustee exposure. A proposed decanting must be consistent with the trustee's fiduciary duties to all beneficiaries.

4. When in doubt, seek court instructions before proceeding. The probate court can provide guidance and protect the trustee.

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