Taxation - Income, Estate and Gift

Adding flexibility to irrevocable trusts can help address tax law uncertainty.

Attorneys across the country have been, and will continue, drafting irrevocable trusts for a multitude of clients who are anxious to capture the increased estate and gift tax exclusion amounts provided in the Tax Cuts and Jobs Act (TCJA).

As originally enacted, the TCJA sunsets on its own at the end of 2025; however, due to the ever-shifting political winds, these increased exemptions could always be terminated or extended.

This article is provided to describe some helpful provisions that can be added to irrevocable trusts to provide greater flexibility in relation to anticipated changes in the law.

In the event changes or modifications are needed, trusts that miss or misstate some provision may find judicial reformation costly and may not always achieve the full extent of the change needed, especially if a not-so-loved one decides to oppose it for some concession or advantage.

Trust protector provisions

The first of the suggested provisions that may assist grantors to achieve the irrevocable trust's purpose are trust protector provisions. Trust protector provisions create a non-fiduciary office or role for an independent third-party, preferably with legal and business acumen, that typically would require a judge in a court of law to perform. Just as parties to a contract may opt to subject the agreement to arbitration or mediation, in essence choosing their own dispute resolution mechanism, a trust protector may serve a similar role by determining if and how a trust may be amended or modified to achieve its stated purposes. The trust protector may act as a failsafe mechanism, providing an independent party to change the trust's situs or terms to address unexpected changes that inevitably come to pass after an irrevocable trust is executed and administered.

Decanting the trust

A second suggested provision is to grant either the trustee or trust protector authority to follow any appropriate decanting statute to transfer assets from the existing trust into a newly formed successor trust. Such provisions may be exceedingly important as the trust ages. Anyone who has administered or been a beneficiary under a trust drafted before major tax law revisions existed will readily understand the importance of such a provision.

An irrevocable trust may easily exist

for fifty years or longer while changes naturally occur in tax and trust laws, product developments in financial instruments and services, long-term economic cycle fluctuations, and sociopolitical environments.

As the trust ages, there eventually may come a point that administration under the trust's antiquated language becomes impossible or unbearable. By invoking such statutory decanting provisions, the trustee or trust protector could transfer the trust assets into an updated trust with language specifically addressing the unforeseen changes or events that could have adverse effects on the trust's taxation, assets, or beneficiaries.

Powers of appointment

Third, powers of appointment may permit trust beneficiaries to direct their trust assets during their life or at their death to charity, to anyone in general, or to a narrowly defined class of people. The power of appointment provides the beneficiaries the ability to direct the trust assets directly to beneficiaries outright or on certain conditions, or indirectly to them by directing assets into updated and legally current trusts for remaining loved ones, similar to the decanting provisions referenced above.

Even when the aging trust contains provisions that would retain the assets in trusts for the intended successor beneficiary, consideration should be given to utilize an available power of appointment to direct assets into an updated trust based upon current tax and trust laws and contemporary trust planning strategies.

Reciprocal trusts

Finally, for spouses contemplating using their enhanced life-time gift tax exemption by creating irrevocable trusts for one another, a note of caution: Beware of the reciprocal trust doctrine. If the net result of the two nearly identical trusts created in close proximity to one another leaves the parties in the same or a substantially similar position as before the trusts were created, the trusts will be disregarded, and each spouse will be deemed a grantor of the other's trust—making the gifts pointless from an estate tax perspective.

Trust differentiating strategies do exist to counter such a characterization and attorneys familiar with this area of the law should utilize them.

Conclusion

Whether the TCJA sunsets in 2025 or extended, it's time for clients to have a conversation with their trusted legal or tax advisors about existing estate planning opportunities and strategies that may vanish very soon.