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Fixing Irrevocable Trusts

A Revocable Living Trust (“RLT”) is an important estate planning tool for many individuals and families, not just the wealthy. RLTs can be modified, altered, or terminated as tax laws change, family dynamics evolve, and other developments unfold.

In addition to RLTs, many clients will encounter *irrevocable* trusts at some point. Irrevocable trusts may take the form of a “Bypass” or “Credit Shelter” trust created after the death of a spouse. Some irrevocable trusts may be established during a Settlor’s life to accomplish gifting, tax planning, or asset protection. While irrevocable trusts are important planning tools, they can be inflexible. **What can be done about a document that, at its creation, was necessary or desirable but, as times have changed, has become outdated or inefficient?**

The most common example of an irrevocable trust is a “Bypass” or “Credit Shelter” trust. Historically, many RLTs established for a married couple were “A/B” trusts. An A/B trust provides that upon the death of the first spouse, the assets of the trust are allocated among two subtrusts: (1) the “A” Trust, or “Survivor’s Trust”, which remains revocable by the survivor during his or her life; and (2) the “B” Trust, or “Bypass Trust”, which becomes *irrevocable* as of the first spouse’s death. The survivor has access to the funds of the Bypass Trust, but cannot revoke it or alter the provisions.

The Bypass Trust is a prime example of an irrevocable trust that can be outdated and inefficient. For some families, Bypass Trusts are still valuable for reasons such as asset protection and ensuring the deceased spouse’s last wishes are fulfilled. However, historically one of the main purposes of the Bypass Trust was to preserve the estate tax exemption of the first spouse to die. Now this same tax benefit can be achieved for many families without the expense and administrative burden of a Bypass Trust as a result of (1) higher estate tax exemption amounts (i.e. \$5,450,000 per person dying in 2016, compared to \$675,000 per person dying in 2001); and (2) portability (i.e., a law that allows the surviving spouse to use the remaining estate tax exemption of the deceased spouse and pass both exemption amounts (totaling \$10,900,000 in 2016) to beneficiaries free of estate tax). Given these tax changes, Bypass Trusts now can actually cause substantially higher capital gains taxes for beneficiaries and administrative expenses without any estate tax benefits.

Other common examples of irrevocable trusts are trusts established for beneficiaries under the terms of an RLT after the death of the Settlor (or Settlers), trusts established as tools for wealth transfer (i.e., a trust established by parents for the benefit of a child to receive lifetime gifts), or life insurance trusts.

Consider a trust established by parents for the benefit of a child. Later in the child's life, the child no longer needs the income from the trust. Rather, the child would prefer to pass on the income to his or her children or grandchildren so that they can make use of the funds and be taxed at their lower tax bracket. However, the trust does not provide for such distributions. What can be done? Here are two options:

1. Petitioning the court to alter or terminate the trust is one option. Such a petition may be based on the consent of the beneficiaries, the consent of the beneficiaries and the settlor, or changed circumstances. However, such a petition is not guaranteed to be approved by the court, and may not be available in all cases. For example, the existence of a "spendthrift clause" in a trust acts as a bar with respect to certain court petitions.
2. Alternatively, "decanting" can be an effective way to alter the terms of a trust without involving the court. Decanting involves "pouring over" assets from one trust into a new trust with more desirable terms. While 23 states have decanting statutes, California is not one of them. However, a trust may make use of the decanting statute of any state by changing the situs (i.e. the state of administration) of the trust to that state.

Additionally, as we addressed in our Winter 2016 newsletter, we are finding that including provisions for a "Trust Protector" in our RLTs, especially those that will ultimately create lifetime trusts for beneficiaries, is a useful "just in case" tool that provides an extra layer of protection and flexibility. The Trust Protector's role is to make sure that if the laws have changed, your original wishes are still carried out in the most efficient way possible. Provisions can be included to grant the Trust Protector the power to tweak or even terminate these irrevocable trusts if future circumstances so require.

Please contact us if you wish to discuss your options regarding an existing irrevocable trust, if you would like to evaluate your existing RLT to ensure future efficiency, or if you'd like more information on this subject.

We recommend reviewing your estate plan if (i) you have not reviewed your plan within the past 3 years; (ii) your circumstances or your beneficiaries' circumstances (i.e. health, wealth, family) have changed; (iii) you no longer wish for the person or entity named as your trustee/executor/agent to act on your behalf; or (iv) you have concerns about asset protection.

If you have questions about this newsletter or wish to review your estate plan, please call our office at (818) 338-3252 or email kdevore@trustplanner.net

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