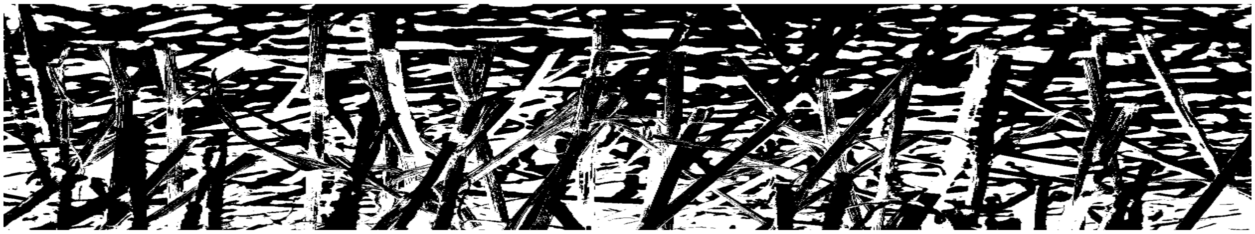

# Jack Straw Fortnightly*

## between

Not a whole lot going on this week.

A pair of letter rulings dealing with the modification of an irrevocable trust to enable the beneficiary to invest in a policy on her own life without risking estate tax inclusion. Which we will discuss at some length in just a moment.

A freedom of information act lawsuit seeking to force disclosure of the thinking behind Rev. Proc. 2018-38. We all wanna know.

And a couple or three state court decisions that have turned up in listserv discussions, but at least some of those can wait.

**first some housekeeping**

I did finally finish that article for Thomson Reuters on the potential difficulties created by section 112 of the uniform trust code, which applies the rules of construction for wills, "as appropriate," to a decedent's revocable trust functioning as a "will substitute." Seven thousand words, including footnotes.

The article expands considerably on some of the ideas we discussed in these pages in connection with the *Craig Trust* litigation in New Hampshire, volume one, number three, with follow-up in several later issues. We are looking at an August or September publication date.

And gearing up now for a breakout session I am presenting Friday morning, May 31 at the Western Regional Planned Giving Conference in how you say greater Los Angeles.

This will be an update of the presentation I gave at the national conference in Las Vegas last year on the mechanics of making a further, deductible gift of part or all of the income stream from a remainder trust or a gift annuity. And reasoning backward to how the initial planning might have been done differently.

Also, yesterday morning Tax Notes published a "viewpoint" article I wrote on how PLR 201825007 was wrongly decided. Again, expanding on a discussion we had back in volume one, number seven, whether the conversion of an "income" trust to a unitrust with an ordering rule allocating realized gains to income should cause the trust to lose its "grandfathered" status as exempt from the generation-skipping transfer tax.

For now, the link is behind a paywall, but when we get reprint permission in a few weeks we will post a copy to the site.

**chicken and/or egg**

So let's look at these letter rulings. Two PLRs, numbered 201919002 and 201919003, identical verbatim. Each issued in response to a request from a trustee, though in each case the requested ruling had to do with estate tax inclusion for a beneficiary --

-- who did also happen to be the trustee, but in theory there is such a thing as separate capacities. "This ruling is directed only to the taxpayer requesting it," etc.

The settlor, since deceased, had created the trust for the benefit of "Child 1" and her descendants. Discretionary distributions of income or principal among the class, subject to an ascertainable standard, remainder at the death of Child 1 among those descendants to whom she might appoint pursuant to a limited testamentary power, otherwise per stirpes in further trust, with again each descendant the trustee of her separate trust, limited testamentary powers at each generation, turtles right the way down. No mention of perpetuities.

Child 1 herself as initial trustee, but with provision for appointment of a "special co-trustee" to authorize any distributions to anyone Child 1 would have a legal obligation to support, etc. Again, similar provisions at each generation.

The trust instrument as drafted also authorized the trustee to purchase insurance on the life of any person in which the trust or any beneficiary has an insurable interest. If on the life of Child 1, then again a "special co-trustee" to exercise "incidents of ownership."[1]

But there was still a concern that her limited testamentary power would itself be treated as an incident of ownership, causing inclusion of policy proceeds in her estate under section 2042.

So she secured a judicial modification of the trust, limiting her testamentary power of appointment to exclude any policy or the proceeds of a policy on her life, placing all incidents of ownership in the hands of the "special co-trustee," and requiring that premiums be paid only from corpus.

The text of the letter rulings paraphrases the state statute under which the reformation was accomplished in such a way as to indicate that the statute is more or less modeled on sections 410 and following of the uniform trust code, while leaving it completely unclear whether the claim was

- that unanticipated circumstances had made it necessary to modify the trust in order to further the settlor's purposes, section 412, or

- that a modification was necessary "to achieve the settlor's tax objectives," section 416, or simply

- that the beneficiaries had consented to a modification that was not inconsistent with a material purpose of the trust, section 411.

Jack says most likely we are looking at section 416, modify to achieve the settlor's tax objectives. Obviously the circumstances were anticipated, and the text of the letter rulings does not indicate that the other beneficiaries were represented.

But as the drafters of the uniform code themselves acknowledged in their commentary to section 416, this kind of thing falls into that category of cases where IRS is not required to play along. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), and such.

The decision of a state trial court does not "determine" federal tax questions. It is to be given "proper regard," but only if there was an actual controversy in which adversarial interests were independently represented. *Estate of Rapp v. Commissioner*, 140 F.3rd 1211 (9th Cir. 1998).

The author of these letter rulings does not ask what representations were made to the state court as to what were the settlor's tax objectives, or whether the modification was in fact necessary or appropriate to achieve these.

But putting all that aside, Jack also finds it curious that, although Child 2 as "special co-trustee" nominally takes all the incidents of ownership, she does not actually enter the picture until Child 1 as trustee has already made a decision[2] to invest trust assets in a policy on her own life.

Jack is not sure we fit within the logic of Rev. Rul. 84-179 -- itself arguably an unnecessarily generous ruling[3] --, which is cited in the text of these letters without any explicit analysis why it should apply. We are not talking about existing policies, we are talking about policies Child 1 as trustee might choose to purchase. And we are talking about a situation in which Child 1 as trustee is also a permitted distributee.

And then although it is nominally Child 2 who decides whether to borrow against the policy to meet a beneficiary's current needs, or to cash the policy in altogether, obviously these decisions will be made in some kind of consultation with Child 1 as "primary" trustee.

And Child 1 can force some of these decisions by not authorizing the payment of premiums from assets that remain under her control.[4]

Of course the same result could have been accomplished by a decanting to a trust of which Child 2 was the sole trustee. Or could it?

In the particular case, no one is entitled to current distributions of "income," so the fact that we are diverting resources to an investment that does not produce a current yield and cannot readily be accessed until after the death of Child 1 does not implicate the duty of impartiality.

But there is still the duty to diversify investment risk, and at some point it may become advisable to cash out the policy or convert it to a paid up policy, or whatnot. Take a look at *In re Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Ind. App. 2009), tr. den. 901 N.E.2d 1128.

What exactly is the separate responsibility of each trustee in making these decisions? Can Child 1 force the issue? can Child 2 resist? and who then has the incidents of ownership?

**just between us kids**

The attorneys general of New York and New Jersey have filed an action in federal district court to require the Treasury and IRS to disclose records concerning the processes by which they developed Rev. Proc. 2018-38, in which the agency abruptly announced that it would no longer require exempt entities other than (c)(3) orgs to submit schedule B with their 990s, identifying their "substantial contributors."

We talked about this a bit in Jack Straw volume one, number nine, and our observation at the time was that a proposed regulation, with notice and comment, would have been the better approach. Also of course dark money.

The complaint itself briefly mentions the plaintiffs' concern that this change will "significantly interfere with their ability to effectively oversee affected organizations operating in New York and New Jersey," but for the most part the allegations have to do with freedom of information act compliance.

Jack wonders why the states could not simply impose their own reporting requirement, replicating schedule B. And it appears New Jersey, at least, is pursuing this course.

We will continue to follow this case as it unfolds, and along the way we may get into the entire recent history of litigation over states -- in particular New York and California -- requiring (c)(4) orgs to submit copies of their schedule B. Those who want to read ahead might start with *Americans for Prosperity v. Becerra*, No. 16-55727 (9th Cir. 2018), and *Citizens United v. Schneiderman*, No. 16-3310 (2d Cir. 2018).

Tl;dr, until IRS stepped in with this rev. proc., the orgs were losing this battle.

**and a couple of state cases**

Last year, in *Horgan v. Cosden*, 249 So.3d 683 (Fla. App. 2d Dist. 2018), review denied, a Florida appeals court affirmed a summary judgment rejecting a trust beneficiary's petition to commute a trust created by his late mother, taking outright distribution of the present value of his income interest and accelerating the remainder to three colleges.

Florida is among thirty-odd states that have enacted some version of the uniform trust code, including as relevant here, something resembling sections 411 and 412, mentioned above, which allow a court to modify or terminate an irrevocable trust where this would not be inconsistent with a "material purpose" of the settlor in creating the trust, or where unanticipated circumstances have arisen, etc.

The drafters of the uniform code took the view that a spendthrift clause, in itself, should not be presumed to express a "material purpose," but they did finally put that portion of section 411 in brackets as optional. The Florida statute allows the court to "consider" a spendthrift clause "as a factor" in making its decision, but does not preclude a modification simply because such a clause is present.

Here the trustee had objected, arguing that the settlor had expressed a "material purpose" by limiting distributions to the son to income only, over his life, and by including a spendthrift clause.

The trial court found this argument sufficient to support a summary judgment for the trustee -- that is, without taking any evidence as to what the settlor may actually have had in mind.[5]

The appeals court affirmed, and the petitioner sought review by the state supreme court on the theory that this result was in conflict with another appeals court in *Goldentrester v. Richard*, 498 So.2d 1303 (Fla. App. 3d Dist. 1986).

The respondent countered that the cases were factually dissimilar. Which is true, but this somewhat misses the petitioner's point.

In *Goldentrester*, the problem was that the testator had left the residue of his estate in equal shares to a niece and a grandnephew who lived in what was then the Soviet Union. Because the testator was concerned that restrictions on private property rights might prevent the legatees from taking possession of their inheritance, he provided that the residue be paid out in installments that, as it turned out, would never exhaust the residue.

In other words, although this was not the testator's intention, he had created a sort of annuity trust with no designated remaindermen, apart from the annuitants themselves.

Further, the testator gave his executors complete discretion to withhold distributions altogether if they determined that any distribution was "unlikely to reach or benefit" the legatees.

And they did.

The niece and grandnephew petitioned the probate court to require complete distribution. The trustees resisted, arguing that the bequest was rendered "impossible or impractical" by the fact that it would likely be reduced by as much as forty pct. through some combination of lawyers' fees, an unfavorable currency exchange rate, and the fact that in the end, the legatees would be able to spend the money only at "government-controlled stores[,] where the range of consumer goods is limited."

And that was the ground on which the trial court decided the case.

The appeals court reversed, holding that the trustees had abused their discretion to withhold distributions. The fact that the inheritance might be depleted did not mean it was "impossible or impractical" to make distributions.

Crucially for our purposes, the appeals court in *Goldentrester* did not actually reach the question whether the inadvertent, makeshift annuity trust should "fail" for want of a remainderman, requiring immediate distribution to the "income" beneficiaries. Instead the case was remanded for findings on what exactly the testator had intended.

But the appeals court did cite comment *a* to section 337 of the Restatement (Second) of Trusts, to the effect that

> The beneficiaries of a trust, if all consent and none is under an incapacity, can compel its termination if the continuance of the trust is not necessary to carry out a material purpose of the trust, although the period fixed by the terms of the trust for its duration has not expired.

The appeals court cautioned the trial court on remand that the mere fact that the trustees would draw fees was not a sufficient reason to continue the trust, citing *White v. Bourne*, 151 Fla. 12, 9 So.2d 170 (1942)

Anyway, this is the principle for which the petitioner in *Horgan* was citing *Goldentrester*. Long before the uniform code, a Florida appeals court had embraced this comment from this section of the Restatement (Second), paraphrasing the *Claflin* doctrine. If terminating the trust early would not frustrate a "material purpose," the beneficiaries could simply consent.

And in enacting its version of section 411, the Florida legislature had made a point of saying the statutory mechanism was "in addition to, and not in derogation of, rights under the common law to modify, amend, terminate, or revoke trusts."

So *Goldentrester* should still be good law. But the problem is this. Even under *Goldentrester*, we still have to determine what were the "material purposes" of the settlor in setting up the trust exactly as she did. In *Horgan*, both the trial court and the appeals court determined, ostensibly from the "plain meaning" of the text of the trust instrument, that the settlor wanted her son to receive income only, over his life, and not have access to principal.

Jack observes that the decision at the trial level to file a cross-motion for summary judgment may have been a strategic error, because it placed the petitioner in the position of conceding that there were no material facts in dispute.

The parties were presenting competing theories as to what the settlor's intentions may have been, and it would appear, at least in hindsight, that the petitioner's best shot might have been to argue that the trust instrument itself was ambiguous on this point. But then one imagines the trustee had all kinds of extrinsic evidence as to what the settlor intended.

**and just briefly**

Already running close to three thousand words, so we will offer this last item as a sort of puzzle.

Last September the Delaware chancery court entered a decision in a case styled *In re Trust f/b/o duPont*, C.A. No. 12904-MG (09/25/18), from which one imagines an appeal is pending.

The master determined that a settlement agreement incorporated in a divorce decree, which required the husband, who held a limited testamentary power to appoint the remainder of a trust created by his father, to exercise that power entirely for the benefit of the children of his first marriage

(a) was not enforceable against the trustee, and (b) was not a partial release of the power.

Did we mention, the husband had since deceased, having exercised his limited power to exclude the children of the first marriage.

Also (c) that the facts did not justify the imposition of a constructive trust over the trust remainder.

This latter issue was complicated by the fact that the trustee was also the planning lawyer for the husband and wrote the will that exercised the limited power for the benefit of a daughter of a later marriage, even though he knew of his client's obligation under the divorce settlement, and in fact had advised his client to obtain an opinion letter on the enforceability of that obligation as against the trust.

The agreement might have been enforceable against the deceased husband's estate, but for some reason the plaintiffs did not timely pursue that course. There may have been no assets there.

More later if this turns up on the appeals docket at the Delaware supreme court.

## detritus

[1]

As it happens, the "special co-trustee" is "Child 2," presumably a sibling, possibly the beneficiary of an identical trust -- which might explain why we have two rulings here, though nothing is said about the possible implications of a reciprocal arrangement.

[2]

The modified paragraph 7.12(a) is quoted at some length in the text of these rulings. On the specific question, when does Child 2 step in as "special co-trustee," the modified paragraph says "if [the] trust intends to purchase" a policy, or does purchase, or holds, etc., as though "the trust" were itself a sentient being.

Obviously it is Child 1 who would "intend."

Another oddity here is that although the modified paragraph 7.12(a) allows Child 1 to remove and replace the "special co-trustee," but not with anyone who would be related or subordinate to her within the meaning of section 672(c), Child 2 already falls within that description. So if we had a section 2038 problem, this does not get rid of it.

[3]

H buys insurance on his own life, transfers the policy to W. She leaves it in a testamentary trust f/b/o her child, with H as trustee. Obviously in that capacity he has incidents of ownership. But the ruling says, well, but he did not put the policy in the trust, she did.

The ruling is in effect an acquiescence in *Estate of Skifter v.*

*Commissioner*, 468 F.2d 699 (2d Cir. 1972), identical facts, in which the appeals court cited legislative history to the effect that section 2042 should be construed as "paralleling" section 2038, *i.e.*, as implicating only retained powers.

[4]

Jack also finds it interesting that the language of the modification refers to paying "the trust's proportionate share" of premiums on a policy "in which it has an ownership interest," as though maybe we have some split dollar planning already on the horizon.

[5]

The petitioner beneficiary had filed a cross-motion for summary judgment, which the trial court denied. As we shall see, this may have been a strategic mistake.

**Jack says, never a silence, always a face at the door.**