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EDITOR'S MESSAGE

The OSBA omnibus probate bill and the Ohio Assn. of Probate Judges Probate Code modernization bill both have now been enacted. The judges' bill (SB 124) has been signed by the Governor and will be effective January 13, 2012. The omnibus bill (SB 117) has also been signed by the Governor and will be effective March 22, 2012. Details of both new laws will be provided by the OSBA committee chairs in the Jan/Feb issue of PLJO. We have earlier published their explanations of each proposal, and the PLJO Legislative Scorecard lists the proposals and cites those explanations. The nine subjects (and authors) are as follows:

- Reduce trustee duties for life insurance in ILITS and other trusts (Barnett)
- Permit and regulate trust decanting (Culler)
- Correct trust income tax credit for tax paid to other states (Robertson)
- Extend anti-lapse statute to trusts, conform wills anti-lapse statute to it (Clark)
- Enact modified version of Uniform Power of Attorney Act (Davis)
- Provide form to title assets in trust and savings statute for other forms of title (Pillari)
- Construction of instruments during estate tax gap (Cooney)
- Changes to PSAs and other Ohio Trust Code provisions (Hindel)

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⁷Restatement 3d Trusts § 50 comment e.

⁸This analysis was provided by my colleagues in the Trusts & Estates group at Marshall & Melhorn, LLC (see <http://www.marshall-melhorn.com/estateplanning.asp>) based on their research for another project.

IS THAT IRREVOCABLE TRUST NOW IRRELEVANT?

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Based on the author's presentation at The Marvin R. Pliskin Advanced Probate and Estate Planning Seminar in Columbus on September 16, 2011

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) (“2010 Act”) included the increase of estate, gift and generation-skipping transfer tax exemptions, the reduction of tax rates, the reunification of the estate and gift tax exemption, and the creation of portability. On December 31, 2012, absent any additional action, the rates, exemptions, and laws in effect prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) return.

Estate planning has long included the use of irrevocable trusts, both created during life such as life insurance trusts, and those that are irrevocable upon death such as a marital/credit shelter trust plan. Strategies used in creating these trusts may have worked so well that living members of senior generations have less wealth than the current maximum federal transfer tax exemptions. For some, the collective family wealth has declined and having assets held in trust is no longer beneficial. Trust income tax rates may be higher than the beneficiaries'. Trustees may be unwilling, particularly in this economic environment, to make unusual, aggressive or alternative investments that the beneficiaries desire.

Some will suggest that these trusts should be modified or terminated, or that substantial

discretionary distributions be made to permit beneficiaries to strategically use the higher tax exemptions and lower rates.

Others, however, will caution us to consider the remarried surviving spouse or child with creditor problems. The trust may own a family business or life insurance policy. Certain trusts were established before the enactment of the generation-skipping transfer (“GST”) tax. Many trusts resulted from leveraged gifting strategies, which would be potentially “wasted” if the trusts were terminated. There are potential risks and complications with modification, termination and other strategies to change an irrevocable trust.

All these issues considered, we ask is that irrevocable trust now irrelevant?

I. METHODS OF MODIFICATION, REFORMATION, TERMINATION, AND OTHER CHANGES TO IRREVOCABLE TRUSTS.¹

The starting point is whether and how an irrevocable trust can be modified or terminated. In absence of any trust provisions on point, we look at the law and more specifically the Ohio Trust Code.

A. JUDICIAL REFORMATION/MODIFICATION.²

1. CHANGE OF CIRCUMSTANCE

O.R.C. § 5804.12 authorizes the Court to modify or terminate a trust for a change in circumstances. “Change in circumstances” finds roots in the common law doctrine of equitable deviation. Comments to analogous Uniform Trust Code (“UTC”) § 412 provide the purpose of equitable deviation is “not to disregard the settlor's intent but to modify inopportune details to effectuate better the settlor's broader purpose.”

Here we ask if the 2010 Act creates a sufficient change in circumstances to merit a

modification or termination of a trust. It may be difficult to suggest that the tax law was the only specific circumstance that was relevant to the Settlor when creating the irrevocable trust. It is reasonable to consider other factors, including dispositive provisions for a spouse or descendants or the nomination of a corporate Trustee to serve from the inception of the Trust.

2. SETTLOR'S TAX OBJECTIVES.

O.R.C. § 5804.16 permits judicial modification of a trust to achieve the Settlor's tax objectives. Comments to analogous UTC § 416 indicate the IRS has blessed such modifications in connection with fixing charitable split interest trusts and Qualified Domestic Trusts, as well as splitting GST trusts. It is unlikely this section would permit a significant change to an irrevocable Trust simply because the tax laws have changed. Instead, this section provides a mechanism to fix a trust so it can comply with the tax laws that are relevant to the Trust.

3. JUDICIAL APPROVAL OF MODIFICATION OR TERMINATION UPON BENEFICIARY CONSENT.

O.R.C. § 5804.11 permits judicial approval of termination or modification upon the consent of the beneficiaries, and in some cases the Settlor,³ even if the modification or termination is inconsistent with a material purpose of the trust. Material purpose is subjective, therefore difficult to discern.⁴ There is little Ohio case law on this point, though in a case of first impression regarding O.R.C. § 5814.11(B), an appeals court upheld the refusal to terminate testamentary trusts because the trusts had to be continued to comply with the testator's material purpose.⁵

B. PRIVATE SETTLEMENT AGREEMENT.

O.R.C. § 5801.10 authorizes Private Settlement Agreements (PSAs). A PSA may be used to modify the terms of the trust as long as it is

not inconsistent with any dominant purpose or objective of the trust. A PSA may not terminate a trust before the trust's stated termination and may not change the interests of the beneficiaries. It would be difficult to use a PSA to substantially modify or terminate an irrevocable trust.

C. COMBINATION OR DIVISION OF TRUSTS.

Combination or division of trusts may be a useful alternative strategy. If the trust is silent on this issue, under O.R.C. § 5804.17 a Trustee may combine trusts or divide a trust if it does not impair the beneficiaries' rights or have an adverse effect on the achievement of the purposes of the trust.

D. DISCRETIONARY DISTRIBUTIONS.

The Trustee may consider making substantial discretionary distributions. The Trustee's authority to do so must be determined. The first consideration is the distribution standard in the trust, and in the absence of a clear standard, the law. For example, O.R.C. § 5801.01(B) defines an "ascertainable standard."

Discretionary distributions may begin or cease upon certain events. The Trustee may be required to take a beneficiary's other assets into account in making distributions. These distribution provisions cannot be overlooked in evaluating whether significant discretionary distributions can be made.

The Trustee's identity is also important as it may further impact the Trustee's distribution authority. For example, a trustee who is a beneficiary may only exercise discretionary powers in accordance with an ascertainable standard and may not exercise a power to make discretionary distributions to satisfy a legal obligation of support that the trustee owes to another person.⁶

E. DISCLAIMERS/RENUNCIATION.

Disclaimers may be useful in dealing with ir-

revocable trusts. Consider the following: husband is deceased. There is a \$10,000,000 QTIP trust for the wife. The wife has a personal estate of \$2,000,000 and has used \$1,000,000 of gift tax exemption. There are two adult children who are the remainder beneficiaries of the QTIP trust. The wife would like to get assets out of the QTIP trust and to her children before 2013.

If the wife disclaims a part of her interest in the trust, problems result. Assume for all purposes that this is not a qualified disclaimer under I.R.C. § 2518. Pursuant to I.R.C. § 2511, a nonqualified disclaimer results in a gift.

With a QTIP trust, there are more traps. I.R.C. § 2519 provides that a disposition of any part of a qualifying income interest for life in any property (to which I.R.C. § 2519 applies) is treated as a transfer of all interests in such property, other than the qualifying income interest. Treas. Reg. § 25.2519-1(a) provides that the transfer of any or all of the spouse's income interest is a transfer by the spouse under I.R.C. § 2511.

Thus, the surviving spouse who tries to give part of a QTIP trust away will probably end up giving it all away, unless there is careful planning. Several Private Letter Rulings have illustrated a solution.⁷ These PLRs describe the division of the QTIP trust into two trusts, with one funded with assets equal to the desired gift amount (over which the spouse then makes the disclaimer) and the other with the balance.

O.R.C. § 5815.36 contains Ohio's disclaimer laws.

G. DECANTING.

Decanting is the commonly used word for the process whereby the trustee of an irrevocable trust distributes assets from one trust to a new trust.⁸ As of November 8, 2011, decanting is before the Ohio legislature in Am. S.B. 117, which would create new Ohio Revised Code sec-

tions 5808.18 and 5808.19. This article will not address the Ohio pending law, which has been the topic of previous articles in this publication. *Id.*

III. NON-TAX ISSUES IN MODIFICATION, REFORMATION, TERMINATION AND OTHER CHANGES TO IRREVOCABLE TRUSTS.

A. ADEQUATE REPRESENTATION OF BENEFICIARIES AND OTHER INTERESTED PARTIES.

In any modification or termination, the involvement or representation of beneficiaries is important. Identifying beneficiaries may be more complex than expected. For example, are adopted descendants included as beneficiaries under the trust document and/or the law? Who are the end remainder beneficiaries? Are any beneficiary classes still open? Consider further the permitted appointees under a power of appointment or the takers in default of the exercise.

The Ohio Revised Code includes relevant definitions: § 5801.01(C) defines a "Beneficiary"; § 5801.01(F) defines a "Current Beneficiary"; and § 5801.01(Q) defines a "Qualified Beneficiary."

Identifying those who may represent beneficiaries is as important. O.R.C. § 5803.02 permits the holder of a general power of appointment to bind permissible appointees and takers in default. O.R.C. § 5803.03 permits certain fiduciaries to act on behalf of beneficiaries, such as guardians and agents. No conflict is permitted to exist between the representative and the person whom the representative represents. Finally, virtual representation exists under O.R.C. § 5803.04.

B. THE ROLE OF THE TRUSTEE/BREACH OF TRUST.

The identity of the Trustee is paramount. If

the Trustee is a beneficiary, there may be a conflict of interest. In such case, if there are Co-Trustees, under O.R.C. § 5807.03 the non-interested Trustees may act in the modification or termination.

The Trustee has duties to the beneficiaries which could be compromised in connection with some of the techniques discussed in this article. If there were a breach of trust, the Trust Code provides for remedies and damages.⁹ Beneficiaries may consent to, ratify, or release the trustee from liability resulting from certain acts that would constitute a breach.¹⁰

IV. TAX ISSUES IN MODIFICATION, REFORMATION, TERMINATION AND OTHER CHANGES TO IRREVOCABLE TRUSTS.

A. TRANSFER TAXES.

Techniques discussed in this article could have inadvertent transfer tax ramifications. Consider the following:

- The release of a general power of appointment is a gift. In modifying or terminating a trust, consider whether there is an inadvertent release of a general power of appointment.
- Before undertaking any action which may (or is intended to) result in a taxable gift, careful consideration should be given to the valuation of the property as an ineffective or inaccurate valuation could result in understating or overstating the amount of the gift.
- Could a modification or termination result in a taxable gift by a beneficiary to another beneficiary (even in the light of court approval), similar to what occurs upon irrevocable assignment of a vested remainder interest?¹¹
- “Clawback.” There has been discussion

that taxable gifts over \$1,000,000 in 2011 and 2012 may result in a tax on those gifts at the later death of the donor under the presumed higher rates then in effect. This outline will not discuss this issue,¹² but should a trustee consider this in determining whether and to what extent termination and/or substantial distributions are appropriate?

B. GENERATION-SKIPPING TRANSFER TAX.

The GST status of a trust should be considered before undertaking any modification, termination or other action over the trust. If the trust is grandfathered for GST purposes, a modification or reformation results in a change that is considered an addition, a pro rata portion of the trust will lose its grandfathered status.¹³ If the change is considered to create a new trust, the grandfathered GST status is lost entirely. *Id.*

In I.R.C. § 2642(a)(3), EGTRRA created qualified severances for GST trusts with partial inclusion ratios. This provision will sunset as of January 1, 2013. GST grandfathered trusts with additions made after 1985 may use the qualified severance rules to sever the trust into two new trusts, one of which is “grandfathered” and one which is not.¹⁴ If a trust has a partial inclusion ratio, a qualified severance should be considered.

C. INCOME TAX.

Trust property does not generally receive a basis adjustment when distributed to a beneficiary.¹⁵ If trust assets have low basis, and there is no desire to or it is not appropriate to elect to recognize the gain at the trust level upon distribution, the Trustee may distribute assets to a beneficiary without any basis adjustment. Upon that beneficiary's death, to the extent the beneficiary still holds those assets, a basis adjustment is available. If the pre-EGTRRA rates return in 2013, there is a risk

that the assets will be subject to an unnecessary estate tax and the income tax savings will be comparatively minimal.

If the beneficiaries' income tax rates are lower than the trust's, there could be meaningful benefit to have the property in the hands of the beneficiaries (whether through termination, substantial modifications, or aggressive discretionary distributions).

Finally, do not underestimate the potential benefits of a trust treated as a grantor trust for income tax purposes before undertaking a modification or termination that might change that status.

E. LIFE INSURANCE - SPECIAL PROBLEMS.

Trusts owning life insurance have special concerns in considering modification, termination, or distributions. Generally, the proceeds of life insurance proceeds are not subject to income tax.¹⁶ There are exceptions for a "transfer for value."¹⁷ Some transactions are not considered a transfer for value, such as the transfer of a policy between grantor trusts both treated as wholly owned by the same grantor or the transfer of a policy to a grantor trust treated as wholly owned by the insured.¹⁸

If the policy is sold from one trust to another, the value of the policy must be determined properly.

Terminating a trust that owns insurance and distribution of the policy to the beneficiaries presents additional complications with respect to the management of the policy, including coordination of premium payments and beneficiary designations. If any owner dies before the insured, that partial interest could be owned by descendants or a spouse, or even the insured.

In 2011 and 2012, additional substantial gifts may be made to trusts to provide funding for future premium payments or to service the debt on any loan in the trust, such as a split dollar

arrangement.¹⁹ These may be more attractive and practical solutions to an insurance trust than a modification or termination.

V. WHY THAT IRREVOCABLE TRUST MAY NOT BE SO IRRELEVANT

There are many aspects of irrevocable trusts that must be considered in evaluating whether a modification, termination or other action is appropriate, even in light of the 2010 Act.

Spendthrift and creditor protection may be particularly valuable to the beneficiaries. Further, not every family situation is appropriate for these modifications or terminations. The Trust might provide insight into the Settlor's desires in these situations, such as of intent regarding family held interests or property, cessation of discretionary distributions upon remarriage, incentive trust provisions, or special needs provisions.

While there are techniques available, there are complexities and challenges in determining whether a trust can, or should, be terminated, modified, or otherwise substantially effected. In the end, the conclusion may be that the irrevocable trust is very relevant.

ENDNOTES:

¹Only certain statutory provisions of the Ohio Trust Code as to modification are presented here. Those specifically not addressed include O.R.C. § 5804.14 (Modification or Termination of Uneconomic Trust) and § 5804.15 (Reformation to Correct Mistakes).

²For detailed further discussion of these methods of modification or termination, please see: Newman, Alan, and Minor, Jamie R., *The Modification and Termination of Irrevocable Trusts under the Ohio Uniform Trust Code*, 16 Probate Law Journal of Ohio 2 (September/October 2005); Acker, Alan S., *Fixing Broken Irrevocable Trusts (The Ohio Trust Code Has Made This Harder!)-Part I*, 19 Probate Law Journal of Ohio 169 (May/June 2009), *Part II*, 19 Probate Law Journal of Ohio 210 (July/August 2009), and *Part III*, 20 Probate Law Journal of Ohio 13 (September/October 2009).

³The Settlor's involvement in this process has been addressed by the drafters of the UTC (and the Ohio Trust Code). Concerns that the Settlor's involvement could result in inclusion in the Settlor's federal estate for estate tax purposes is the genesis of the court involvement in

Ohio's statute. The comments to UTC § 411, specifically the 2004 Amendment, explain this issue in detail.

⁴See Hindel, Joanne E., "Did My Dad Say That? He Didn't Really Mean It!": *Ascertaining a Trust's Material Purpose*," 19 Probate Law Journal of Ohio 205, July/Aug 2005; Evans, Christina D. and Davis, Richard E., "The Case for Liberalizing the Provisions for Modification or Termination of Irrevocable Trusts by Beneficiary Consent," 20 Probate Law Journal of Ohio 67 (Nov/Dec 2009); Acker, Alan S., *Fixing Broken Irrevocable Trusts (The Ohio Trust Code Has Made This Harder!) - Part II*," 19 Probate Law Journal of Ohio 210 (July/Aug 2009).

⁵*Vaughn v. Huntington National Bank*, 5th Dist. No. 2008 AP 03 0023, 2009-Ohio-598.

⁶O.R.C. § 5808.14(B).

⁷See PLR 201118007, PLR 201119004. In each ruling, upon termination of the QTIP trust the property is distributed to individual beneficiaries, not a "bypass" trust. If that were the case, and assuming the spouse is also the sole beneficiary of the bypass trust, the spouse would have to disclaim the interest in the bypass trust. The gift tax result may make this strategy unattractive.

⁸For various definitions of "decanting" in this context see Culler, M. Patricia, *Demystifying Decanting and Ohio's Proposed Statute*, 20 Probate Law Journal of Ohio 135 (January/February 2010); Schwartz, Michael G. and Maag, Marilyn J., *Private Settlement Agreements or Proposed Decanting Statutes: Which Will Be the Better Fit?*, 21 Probate Law Journal of Ohio 7 (July/August 2011); Aghdami, Farhad and Chadwick, Jeffrey D., *Gradually, then Suddenly: Trust Decanting Comes of Age*, 2011 ABATAX-CLE 0506001, May, 2011.

⁹O.R.C. § 5810.01, § 5810.02.

¹⁰O.R.C. § 5810.09.

¹¹See Treas. Reg. § 25.2511-1(h)(6).

¹²Numerous commentaries are available that detail this concern. See, for example, Aucutt, Ronald D., *Estate Tax Changes Past, Present and Future*, 2011 ABATAX-CLE 0507005 (May 7, 2011).

¹³See Harrington, 850-2nd T.M., *Generation-Skipping Transfer Tax*, at A-100.

¹⁴Treas. Reg. § 26.2642-6(g)(2).

¹⁵An exception exists in I.R.C. § 643(e); See Acker, 852-3rd T.M., *Income Taxation of Trusts and Estates* at A-104-A-105.

¹⁶I.R.C. § 101(a)(1).

¹⁷I.R.C. § 101(b).

¹⁸See Rev. Proc. 2007-13

¹⁹See Warshaw, Melvin A., *Life Insurance Planning After the 2010 Act*, 150 No. 4 Trusts & Estates 48 (April, 2011). Mr. Warshaw also suggests that establishing a new ILIT (with grantor trust status) and then selling a life insurance policy to that trust for a note in 2011 and 2012 is an efficient way to leverage GST exemption, as the only exemption that needs to be allocated is to the initial gift upon creation of the new ILIT.

MULTIPLE OHIO LIVING WILL DECLARATIONS

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A written declaration signed by an adult of sound mind may express the decision of said person (the "Declarant") concerning the use, continuation, withholding or withdrawal of life-sustaining treatment.¹ These statements, known as "Living Will Declarations", are authorized by the Ohio Revised Code.² The Declarant may also designate one or more persons who are to be notified (the "Contact Persons") by the Declarant's attending physician at any time that life-sustaining treatment would be withheld or withdrawn pursuant to the declaration.³

The Living Will Declaration becomes operative when (i) the Declarant is in a terminal condition or in a permanently unconscious state, (ii) the Declarant is no longer able to make informed decisions regarding the administration of life-sustaining treatment, and (iii) there is no reasonable possibility that the Declarant will regain the capacity to make those decisions. If the attending physician is aware of the Living Will Declaration, then the attending physician is required to make a good faith effort and to use reasonable diligence to notify the Contact Persons before taking action in accordance with the terms of the Living Will Declaration.⁴

Consider the example that follows: Barb names Fred as her sole Contact Person in her Living Will Declaration. Several years later Barb signs another Living Will Declaration in which she names Frank as her sole Contact Person. The new Living Will Declaration naming Frank makes no reference to her prior Living Will Declaration naming Fred. Neither Fred nor Frank are related to Barb. Barb has had no contact with Fred for several years, and in fact hostility exists between them. After signing the new Living Will Declaration, Barb suf-