UNIFORM TRUST CODE SECTIONS 411, 303 (OK, they fixed 303), AND 304 INTERACT WITH IRC SECTIONS 2036 AND 2038 TO PRESENT AN ESTATE TAX ISSUE

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Recalling the tale:
THE EMPEROR'S NEW CLOTHES

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A. ESTATE TAXATION RELATED TO THE UNIFORM TRUST CODE

The Second Restatement of Trusts is generally followed in Arizona.[1] Section 338(1) of the Second Restatement permits the settlor and all beneficiaries to modify or terminate a trust, regardless of the purposes of the trust. It is questioned here in Arizona whether that could be accomplished out of court, but there is authority that such is the law in other jurisdictions. ARS Section 14-10411.A (having the language of Uniform Trust Code ("UTC") Section 411(a)), if it had become effective, may have restated the law, subject to the issue of the requirement of court participation under existing law.[2]

Brief statement of the UTC and the estate tax concern. The National Conference of Commissioners on Uniform State Laws ("NCCUSL") first published a draft for discussion purposes of the "Trust Act" on November 9, 1995, which became known as the "Uniform Trust Act" in 1998, and finally as the "Uniform Trust Code" on March 10, 2000. UTC Section 411(a)[3] expressly provides that the settlor and all beneficiaries can modify or terminate the trust, impliedly outside of court. IRC Sections 2036 and 2038 provide that the power of a decedent-donor (whether or not exercisable in conjunction with others, whether or not adverse) over gifted property to terminate or alter the beneficial enjoyment of the property causes the property to be includable in the gross estate of the decedent. Many believe inclusion is more likely due to this interplay. Some strongly advocate that no consideration be given to changing Section 411(a). They reason that since UTC Section 411(a) merely incorporates the Section 338(1) of the Second Restatement of Trusts, which, they assert, currently provides for the settlor's power described above, any adverse tax result arising from the language of Section 411(a) is a problem under existing law. Therefore, codification of long established law will not adversely affect a settlor, because there is no realistic possibility that an estate tax problem can now surface when it had not already. This view is somewhat persuasive, but it reminds the story of the promenading king, whose nakedness was ignored by everyone - until a little boy stepped forward and made it impossible to overlook.

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[1] Olivas v. Board of National Missions of the Presbyterian Church, 1 Ariz. App. 543, 548, 405 P.2d 481, 486 (App. 1965). The case was transferred from the Arizona Supreme Court under then ARS Section 12-120.23.

[2] The Arizona Uniform Trust Code was repealed April 23, 2004, prior to its effective date of January 1, 2006. Reference is made to the former statutes because this portion of the discussion briefly addresses the possible effect of the UTC on Arizona law, which may be representative of many other jurisdictions.

[3] Current UTC Section 411(a) was not added to the model UTC until April 14, 2000, in an interim draft, without comment regarding any estate tax issues, but the comment in the April 25, 2001 versions of the July 28-August 4, 2000 NCCUSL Annual Conference Draft and Final Act dismisses any tax concern:

> The settlor's right to join the beneficiaries in terminating or modifying a trust under this section does not rise to the level of a taxable power. *See* Treas. Reg. § 20.2038-1(a)(2). No gift tax consequences result from a termination as long as the beneficiaries agree to distribute the trust property in accordance with the value of their proportionate interests.

The Amendments to the UTC made at the July 30 – August 6, 2004 NCCUSL gathering now provide that the entire subsection is optional, or if adopted that perfunctory court approval may be obtained. However, even after amendment, there is neither (1) an express requirement that court approval be obtained (although it is questionable what benefit such a requirement would provide) nor (2) a negation of the existing common law recognizing the power of a settlor to consent to trust modification or termination. The 2004 Amendments are discussed below in this Part A and in fn. 22.

UTC Section 411(a) highlights existing estate tax risk. The codification by the NCCUSL of the settlor power of Second Restatement Section 338(1) has the effect of making more clear the interaction between the power and IRC Sections 2036 and 2038. This permitted a few little boys – and girls[4] – to see what was always there. (At least we think we see it.) And in Arizona, ARS Section 14-10411.A did certainly direct attention to the issue. There were, however, at least two other sections of the Arizona UTC (incorporating Sections 303 and 304) that aggravated the tax problem by permitting less than all the beneficiaries to consent with the settlor to modify or terminate a trust. The estate tax issue is discussed in depth in Part B below.

UTC Section 303 virtual representation power no longer increases estate tax risk (except for states that enacted the pre-2004 UTC). UTC Section 303 permits a parent to act for a minor child. Prior to the August 2004 changes to the UTC, this could permit a parent to set up a trust for the child, and then modify it unilaterally until the child reaches majority. The comment to the UTC Section 303 provides that the parent cannot so act for the child if the parent has a conflict of interest. The comment lists the parent acting as a trustee as being such a conflict, but does not list the parent as a settlor as constituting a conflict. Perhaps there would be a conflict if the parent acted to benefit the parent, such as by revoking the trust or modifying it to permit satisfaction of the parent's support obligations, but no conflict if the parent acted by terminating the trust or merely changing the method of determining distributions to the trust. Following consensus at an ACTEC meeting in Vancouver in July in which this issue was again validated, the August 2004 change to Section 301 adds a section (d), which now prohibits a parent who is a settlor from possessing such a power with respect to his or her child. However, those settlors in states that had enacted original UTC Section 303 may remain "in play." No comments were published with the August 2004 amendments, and there is no indication that NCCUSL recommends that jurisdictions that had enacted the pre-2004 UTC amend their respective statutes to mitigate any potential tax exposure resulting therefrom, although its Summer 2004 UTC Notes mentions the issue and "recognizes that it may be desirable" to so do.

UTC Section 304 virtual representation power increases estate tax risk. The virtual representation provision of UTC Section 304 further empowers the settlor by permitting less than all beneficiaries to act with the settlor to modify or terminate a trust, if one or more of such beneficiaries has a "substantially identical interest" to another who is "a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable." The section and the comment to it do not limit its application to court proceedings. Therefore, under any interpretation of Helvering v Helmholz, discussed below, the existence of the power at death of the settlor in such fact pattern may cause estate tax inclusion. This issue remains outstanding.

Can settlor waive a UTC Section 411(a) power? Can virtual representation powers be waived or denied? An ancillary issue is whether Section 304 is so integrally incorporated into Section 411(a) in a manner that will also negate any attempt to waive out of it pursuant to Section 105(b). This same issue exists as to Section 303, and continues to remain important in jurisdictions that adopted the pre-2004 UTC. Some read UTC Section 411(a) to be nonwaivable, but many believe that it may be "drafted around." See EXHIBIT "A" for a discussion of this issue. The law should expressly permit the power to be waivable by the settlor, regardless of enactment of the UTC. The comments provide no guidance.

UTC virtual representation powers are new, and not codification of existing law. The UTC comments confirm that the virtual representation provisions are not existing law, such that any enhanced risk of federal estate taxation resulting from the settlor's power to modify or terminate a

[4] Truth be told, it was Susan K. Smith, Esq. in Arizona that first pointed at the problem so far as I know. Another Arizona estate tax expert to whom I went for insight, David Weiss, Esq., immediately understood the estate tax issue and separately wrote the Governor's office.

trust with less than all beneficiaries arises solely from the UTC, and not from the law as it existed in Arizona prior to the UTC. If such cannot be waived by the terms of the trust instrument, then unavoidably IRC Sections 2036 and 2038 have even greater likelihood of application under the UTC than is argued to arise under existing law. (In any event, the estate tax issue is extant, even without consideration of UTC Sections 303 and 304. See the discussion in Part B below.)

Section 2036 power must be "retained," but Section 2038 power need merely be held at death. IRC Section 2036 should not apply if a new law grants a power to a settlor after the trust is created, because the power was not "retained." The reach of IRC Section 2038 is different.[5]

Section 2038 does not require a power be "retained" to create gross estate inclusion, only that it be held at death of a decedent, "without regard to when or from what source the decedent acquired the power". Rev. Rul. 70-348, 1970 CB 193, makes this clear in holding that a subsequently acquired custodianship of an UGMA account by a donor trips Section 2038(a)(1).

Theoretically, IRC Section 2036 may apply if a new power (UTC Section 411, as affected by UTC Sections 303 and 304) arises due to enactment of new law, and then thereafter the trust is created, even if the effective date of the new law is after the creation of the trust.[6]

Power held under operation of law alone held a taxable power. The argument that "if a power held at death by a decedent otherwise within the ambit of Sections 2036 or 2038 arises only by operation of law, then it is not so subject to taxation" is flawed. By such reasoning, if a statute provides that a trust is revocable in absence of a provision to the contrary, then Section 2038 will not apply. It has been held that a power granted under law alone will cause the estate of a donor of an UGMA to be taxable under both Sections 2036 and 2038. Prudowsky v. Commissioner, 55 TC 890 (1971), *aff'd per curiam*, 465 F.2d 62 (7th Cir 1972). *See also* Rev. Rul. 2004-64, 2004-27 IRB 7 [7].

The Tax Court in Hauptfuhrer's Estate v Comm'r, 9 TCM 974 (1950), *aff'd*, 195 F.2d 458 (3d Cir. 1952) (discussed below) states:

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[5] White v. Poor, 296 US 98 (1935), held that a power was not "retained" under a predecessor provision to Section 2038 when it was re-acquired by the decedent. That prompted Congress to amend the provision to eliminate the word "retained" such that under modern Section 2038(a)(1), it is not necessary that power held by a decedent have always been retained by a decedent. The predecessor to Section 2036 contained the same relevant language, but neither it nor modern Section 2036 was changed as Section 2038 was.

[6] If UTC Sections 303 or 304 constitute new powers, then a settlor of an irrevocable trust formed after enactment of the UTC, even if before the effective date, in theory would have "retained" the power, since the power existed at all times after the creation of the trust, subject only to the contingency of survival until the effective date (which contingency may be ignored under the Regulations). See Reg. Section 20.2036-1(b)(3). However, if, as may be the case, the power described in UTC Section 411(a) always existed pursuant to Second Restatement Section 338(1), then none of this "retained" business matters for purposes of powers granted under that provision alone. Furthermore, if an irrevocable trust were created prior to enactment of the UTC, then Section 2036 would not apply to the settlor estate due to powers arising from UTC Sections 303 or 304. Application of IRC Section 2038 is governed by different rules. Under IRC Section 2038, the only issue is whether the powers are actually held at death, because they can be acquired at any time, and apparently time contingencies are respected for such purpose.

[7] The ruling confirms that there is no gift when a settlor of a grantor trust incurs and pays the income tax of the trust. The ruling also holds that the right to reimbursement of income tax to settlor of trust taxable income will cause Section 2036(a)(1) inclusion in the gross estate of the settlor, regardless of whether the right arises by terms of the trust instrument or "if, under applicable state law, the trustee must reimburse" the settlor for his or her personal income tax liability.

> "The [US Supreme Court in Helmholz] did not say that Congress could not tax in the estate of a settlor property of a trust which he held a power to terminate, whether the power was reserved in the trust agreement or was conferred by state law."

There is really not much question that the source of the power is not determinative. *See* 2 Casner & Pennell, Estate Planning §7.3.4.2 (6th ed. 1999). Castleberry v Comm'r, 68 TC 682 (1977), *rev'd*, Wyly's Estate v Comm'r, 610 F.2d 1282 (5th Cir. 1980)(discussed below).

A veto power can be a taxable power. Veto power of a settlor is treated as a comparable power. Rev. Rul. 70-513, 1970-2 CB 194; Thorp v. Comm'r, 164 F2d 966 (3d Cir. 1947), *cert. denied*, 333 US 843 (1948); Estate of Grossman v. Comm'r, 27 T.C. 707 (1957). *See* 2 Casner & Pennell, Estate Planning §7.3.3 n.52 and accompanying text (6th ed. 1999).

Requirement of perfunctory court approval is not determinative. NCCUSL's 2004 Amendments additionally provide for optional language if Section 411(a) is not omitted entirely to require a court to order modification or termination if petitioned to so do and the settlor and all beneficiaries agree:

> "If upon petition the court finds that the settlor and all beneficiaries consent to the modification or termination of an irrevocable trust, the court shall enter an order approving the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust."

If this provision does not "modify" the existing common law right of such persons to modify or terminate the trust out of court, but merely permits elective access to a forum, then, pursuant to UTC Section 106, that extra-judicial right may remain unabated. Even if were found that such language requires court approval to exercise the right in all circumstances, such essentially ministerial act would not likely be seen to be any real impediment to the joint exercise of the suspect power of a settlor in a way that would insulate against the estate tax risk identified in this outline.

In Estate of Gutchess v. Comm'r, 46 T.C. 554 (1966), the court held that Section 2036 did not apply to an estate of a husband who gifted his residence to his wife, but continued to reside therein. The Tax Court ignored the government's argument that such use was a retention of use or enjoyment because he retained the right to reside there unless and until his spouse obtained a court decree to evict him, and no such decree was obtained. In Castleberry v Comm'r, 68 TC 682 (1977), *rev'd*, Wyly's Estate v Comm'r, 610 F.2d 1282 (5th Cir. 1980)(discussed further below in Part C), the Tax Court discussed Estate of Gutchess:

> "We do not think that Estate of Gutchess is applicable. In that case, the decedent lived in the residence only at the sufferance of his wife. He would not have been able lawfully to continue to reside in the residence if his wife withdrew her consent. She could, had she chosen to do so, have had him ejected by court order. In this case, however, decedent's right to the community income was not defeasible. His right was not dependent upon the actions or inactions of his spouse. **The dictum regarding rights under Ohio law referred, in context, to the mere requirement that an action be brought and a court decree obtained in order to remove the husband. The "requirement" referred to a mere procedural difficulty in the enforcement of the transferee's right to exclude the transferor, not a substantive diminution of the right itself.** [emphasis added]"

If the purpose of NCCUSL in adding the optional sentence was to attempt to avoid possible application of Sections 2036 or 2038 to the powers otherwise possessed by a decedent under Section 411(a), then it may well have missed the mark. Adding "mere procedural difficulty," and perhaps voluntary at that, runs against the grain of Tax Court holdings that would ignore such requirements.

Amount includable under Section 2038 determined differently than if under Section 2036. The amount includable in the gross estate of a settlor under IRC Section 2038 is more limited than if includable under IRC Section 2036. "The amount includible under section 2038 of the Code is limited to the value of the property interest that was subject to the decedent's power. Walter v. Comm'r, 341 F. 2d 182 (1965)." Rev. Rul. 70-513, 1970-2 CB 194. The amount includable under IRC Section 2036 is generally the entirety of the property interest with respect to which the transferor retained the right to income or retained the relevant power to control enjoyment of others in its corpus or income.

B. HELMHOLZ AND REG. SECTION 20.2038-1(a) DISCUSSION

The US Supreme Court case, Helvering v Helmholz, 296 US 93 (1935), involved a joint power only to terminate a trust held by a beneficiary who was also the settlor (and therefore held the power redundantly), and did not involve a joint power held by a settlor who was not a beneficiary, the latter overwhelmingly being the fact pattern under which the UTC Section 411(a) estate tax issue would arise.

The facts of the case are atypical of irrevocable gifting trusts. The trust that is at the center of the case is similar in effect, if not also by intent, to a voting trust. The decedent and her parents and siblings transferred their respective shares of stock in a corporation to a trust, wherein decedent and the others each received his or her share of income, and on death he or she retained a special power of appointment to appoint his or her income share to natural persons, and if none, then to his or her issue, and if none the others, and on termination the shares themselves would be distributed to the remaining income holders in the same proportions as they were receiving the income. At death of the decedent apparently there was no estate tax section equivalent to Section 2036, and retained interests subject to special powers of appointment were not automatically includable in the gross estate of the donor. So the only estate tax issue was whether the predecessor to Section 2038 (Section 302(d) of the Revenue Act of 1926) applied.

This discussion assumes Helmholz remains good law. There is a belief that those who are asserting application of IRC Section 2038 to UTC 411(a) and Second Restatement Section 338(1) are arguing otherwise. It is not necessary to take a position that the holding is suspect in order to put forth a serious argument of estate tax risk. What is at issue is the proper interpretation of the opinion, and proper application to the relevant set of facts. In Helmholz the facts and applicable tax law are so unique that it is difficult to be comfortable that any typical trust arrangement is likely to be sufficiently similar to warrant any reliance of the holding. Additionally, the question of what exactly Justice Roberts is saying is not the apex of clarity. The holding may be limited to its facts: a situation in which the settlor of an irrevocable trust is a beneficiary, and not when the settlor is not a beneficiary. It may be further limited to facts involving multiple settlors who also are beneficiaries. Therefore, if one is presented with facts not within the unique facts of Helmholz, no comfort can necessarily be taken from the case.[8]

Regulation Section 20.2038-1(a). Reg. Section 20.2038-1(a) contains the following language (derived from Helvering v Helmholz, 296 US 93 (1935)):

"However, section 2038 does not apply-

. . .

(2) If the decedent's power could be exercised only with the consent of all parties having an interest

[8] Helmholz referred only to a power of termination, and not modification, although this is not likely of import.

(vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law; ..."

What does Regulation Section 20.2038-1(a) mean? The term "parties" most likely means the trust beneficiaries exclusively (including settlors who are beneficiaries). The context of the use of the word “parties” is important. It is applied in the context of an economic or property interest: "parties having an interest (vested or contingent)". Other authority also exists for this construction. From Hauptfuhrer's Estate v Comm'r, 9 TCM 974 (1950), *aff'd*, 195 F.2d 458 (3d Cir. 1952):

> "The [US Supreme Court in Helmholz] did not say that Congress could not tax in the estate of a settlor property of a trust which he held a power to terminate, whether the power was reserved in the trust agreement or was conferred by state law. This was the position taken by the Circuit Court of Appeals for the Third Circuit in Commissioner v. Allen, 108 Fed.(2d) 961 [24 AFTR 118], certiorari denied, 309 U.S. 680, where it said:
>
> > "*** In the Helmholz case the settlor was one of the beneficiaries to whom the power was given by the trust indenture to terminate the trust and return the property to the settlor if all of the beneficiaries agreed in writing that that should be done. No power to revoke the transfer or change the beneficiaries was reserved to the settlor as such. Her only power in connection with a possible termination of the trust and a return of the property to herself came to her as one of the beneficiaries and not as the settlor. Hence, the case was not within the intent of the statute. ***
> >
> > "*** The thing of importance in the Helmholz case was that the power of revocation there rested with the beneficiaries and not with the settlor as such. ***"

See also Commissioner v. Allen, 108 F.2d 961 (3d Cir. 1939).

The estate tax concern with respect to IRC Section 2038 is presented as follows:

Since the regulation section is conjunctive, both conditions must be met to exclude a settlor power from the application of Section 2038(a)(1). Otherwise it is taxable under Section 2038(a)(1).

Let’s recap the 2 conditions to be satisfied to avoid application of the statute:

(1) the decedent's power could be exercised only with the consent of all “parties” having an interest (vested or contingent) in the transferred property; and

(2) the power adds nothing to the rights of the “parties” under local law.

The first condition is clearly satisfied by UTC Section 411(a), and presumably Second Restatement Section 338(1). However, the second condition is not. The decedent's power is necessary to affect interests in the trust, because without the decedent's act, UTC Section 411(a) is inoperative. In other words, decedent's power as settlor only, if exercised, adds something to the power of beneficiaries alone. Therefore, the power of a non-beneficiary settlor of the type described in Section 411(a) is not excluded from being a power described in Section 2038(a)(1) by the regulation provision above, and is taxable.

The Seventh Circuit in Swain v US, 147 F.3d 564 (1998), decided a plain vanilla case involving a settlor having an express power in a trust agreement to modify the trust with less than all beneficiaries. The court held the power was clearly within Section 2038(a)(1).[9] The court reiterated its prior decision, in which it had not considered "whether Section 2038(a)(1) covers powers exercisable by the decedent in conjunction with all the beneficiaries." So it is an expressly open question in the Seventh Circuit, even without UTC Sections 303 and 304.

Does Helmholz control IRC Section 2036? Does Regulation Section 20.2038-1(a) control IRC Section 2036? Helmholz and the Reg. Section 20.2038-1(a) apply to IRC Section 2038. The rationale for the application of constitutional due process requirements by Helmholz to IRC Section 2038 seems to be the same for IRC Section 2036(a)(2). However the regulation literally does not apply to IRC Section 2036. *See* GCM 33512 (1967). This distinction may be significant if the application of Helmholz is narrow. Justice Roberts emphasizes that the most important issue in the holding of Helmholz is the retroactive application of the predecessor to IRC Section 2038(a)(1):

> Another and more serious objection to the application of section 302(d) in the present instance is its retroactive operation. The transfer was complete at the time of the creation of the trust. There remained no interest in the grantor. She reserved no power in herself alone to revoke, to alter, or to amend. Under the revenue act then in force, the transfer was not taxable as intended to take effect in possession or in enjoyment at her death. Reinecke v. Northern Trust Company, 278 U. S. 339, 49 S. Ct. 123, 73 L. Ed. 410, 66 A. L. R. 397. If section 302 (d) of the Act of 1926 could fairly be considered as intended to apply in the instant case, its operation would violate the Fifth Amendment. Nichols v. Coolidge, 274 U. S. 531, 47 S. Ct. 710, 71 L. Ed. 1184, 52 A. L. R. 1081.[10]

This specific constitutional impediment to application of either or both IRC Sections 2036 and 2038 is not present with respect to any trust today, since it would only apply to trusts created before 1926 by settlors living presently. To the extent due process protection against retroactive legislation offered shelter from taxation to the Irene C. Helmholz Estate, it is unavailable now. Nonetheless, the applicable regulation may protect against taxation under Section 2038(a)(1). As observed above, such is apparently not the case regarding application of IRC Section 2036(a)(2). The remaining thread to which an estate can cling to avoid estate taxation in a primae facie case implicating the Section 2036(a)(2) is the following from Helmholz:

> The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.

[9] UTC Section 411 in conjunction with UTC Sections 303 (in pre-2004 UTC legislation) or 304, when facts so dictate, may tee up the ball for the IRS, by permitting the settlor with less than all of the beneficiaries to modify or terminate a trust.

[10] Three of the Justices, Brandeis, Stone, and Cardozo, concurred in the result on the ground last stated above. The Third Circuit raises a question as to the continued viability of Helmholz, "[W]e need not decide to what extent, if any, the Helmholz case has survived the impact" of later cases. The comment may be limited to the precedential value of Helmholz with respect to its holding regarding the constitutionality of the statute's retroactive application as applied to a case in which the interests of the beneficiaries were not "substantially adverse." Thorp's Estate v Comm'r, 164 F2d 966 (3d Cir. 1947).

The Court did hold that either theory would protect against taxation. The loss of the constitutional theory of unfair retroactivity in a case today is not necessarily fatal to protection, but it exposes some additional weakness in application of the Helmholz holding to assist in avoiding the estate string provisions.

The language of the opinion at least invites the question of whether the Court properly understood and considered the relevant trust law. It appears the court believed the law of Wisconsin (presumed to be the First Restatement of Trusts [11]) to permit beneficiaries alone to terminate a trust. The Court did not discuss the "Claflin rule," i.e., the requirement to establish that no material purpose of the trust would be frustrated as a condition to permitting the beneficiaries alone to terminate the trust, if the settlor's consent is not forthcoming. The Court noted that the trust instrument permitted "the then beneficiaries, other than testamentary appointees" to terminate the trust. Nonetheless the Court stated:

> Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits *all the beneficiaries* to terminate the trust [emphasis added].

In at least one treatise it is questioned whether the Court ignored its own findings of fact:

> Consequently, the power which the decedent reserved in the Helmholz case went beyond anything to which she would have been entitled in the absence of the explicit reservation of the right to revoke the trust and according to the Court's own reasoning should have made the trust taxable.[12]

Strangi appeal is not going to change things. Estate of Strangi v Comm'r, TC Memo 2003-145 (2003)("Strangi II"), is presently on appeal to be decided by the Fifth Circuit. It involved the application of IRC Section 2036(a)(2) to cause the estate of a deceased minority shareholder of the corporate general partner of a limited partnership to include the value of limited partner interest gifted by the decedent in his gross estate. Strangi II is not particularly relevant in examining the estate tax issue with respect to UTC Section 411(a), save the following. Strangi II and the recent split dollar changes are strong messages that just because the government has not questioned a common practice doesn't mean it won't be attacked - perhaps successfully - in the future. One concern is that the estate tax issues arising from UTC powers will be used as a bargaining chip in an audit involving other issues.

C. TEXAS COMMUNITY PROPERTY CASES; DEATH BENEFITS TO FAMILIES OF SHAREHOLDER-EMPLOYEES CASES; OTHER CASES FAVORABLE TO ESTATES

There are some lines of cases in which powers possessed at death by creators of rights were found nontaxable. The cases involved the issue of federal estate tax inclusion:

(1) arising from retained rights in gifts of community property between Texas spouses;

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[11] The Court referenced "Restatement of the Law of Trusts, §§ 337, 338" as the applicable trust law. It stated "We are referred to no authority to the contrary in Wisconsin, the place of the transaction." The relevant language of First Restatement Section 337 and its comment a. are identical to those of the Second Restatement.

[12] Lowndes, Kramer, & McCord, Federal Estate and Gift Taxes (3d Ed. 1974) Section 8.3 at 145-146.

(2) in connection with powers of an employee-shareholder of a corporation to affect death benefits paid to his family;

(3) arising from gifts to a spouse, followed by life estate created when the donee-spouse died; and

(4) when the decedent held a power as a beneficiary of the type in Helmholz.

These holdings were all favorable to the taxpayers. A discussion of these decisions follows.

Community Property Cases. In Texas, income from separate property (whether or not gifted from a spouse) is community property. In Wyly's Estate v Comm'r, 610 F.2d 1282 (5th Cir. 1980), the Fifth Circuit, in a 2-1 decision, held that the income right of the donor spouse granted by operation of law in the gifted property is not an IRC Section 2036(a)(1) retained right. In the facts of the case the husband had given his wife property to be her sole and separate property.

The majority found that the income right held by the husband at death was too speculative and contingent to be taxable under IRC Section 2036. It extensively analyzed Texas community property law, and at one point stated:

> "Thus, existing Texas law in the area teaches that the only relevant consequence of a spouse's ownership of a community property interest in income from the other spouse's separate property is an inchoate standing to complain that the other spouse made an excessive or capricious gift to a third party, or to demand an accounting on dissolution of the marriage or partition, alleging the income was used to improve the other spouse's separate property. Does this constitute a 'right to the income?' We think not, and proceed to an examination of the Act to explain why."

The Wyly's Estate majority also held that retention of a right by operation of law will not be sufficient to cause application of IRC Section 2036(a)(1), specifically when the transferor has done all he can do to part with the transferred interest:

> "We do not believe that an interest, created solely by operation of law as the unavoidable result of what was in form and within the intendment of the parties the most complete conveyance possible, is a retention within the Act. There must be some act or omission on the part of the donor, such as an express or an implied agreement between donor and donee at the time of the transfer, which provides for retention. See, e.g., Guynn v. United States, 437 F.2d 1148 [27 AFTR 2d 71-1653] (4 Cir. 1971); First National Bank of Shreveport v. United States, 342 F.2d 415 [15 AFTR 2d 1317] (5 Cir. 1965); Skinner's Estate v. United States, 316 F.2d 517 [11 AFTR 2d 1855] (3 Cir. 1963); Estate of McNichol v. Commissioner, 265 F.2d 667 [3 AFTR 2d 1838] (3 Cir. 1959)."

Certainly this is hopeful. However, Judge Roney dissented in Wyly's Estate for the sole purpose of disagreeing with the majority's conclusion that an interest retained by operation of law would not come within the grasp of IRC Section 2036:

> "RONEY, Circuit Judge, concurring in part and dissenting in part: I concur in the result and that portion of the opinion which holds that the community interest of the donors in the income of the donated property was insufficient to amount to 'the right to income from, the property' as provided in 26 U.S.C.A. §2036(a)(1). Thus, I agree that no portion of the donated property should be included in the estates of the deceased taxpayers. I respectfully dissent, however, from that portion of the opinion which holds that such interest was not

> 'retained' 'under' the transfers here made. If after the transfers the donors' remaining interest in the gifted property had been such as to qualify as 'the right to income' under §2036(a)(1), the tax consequences should be the same whether that interest was retained by the express provisions of donative instruments, or arose by operation of law in effect at the time of the gift. The cases relied upon by Judge Garza do not compel a contrary decision. They hold only that a retained interest taxable under §2036 may be created by an express or an implied agreement between the donor and donee at the time of transfer. Rose v. United States, 511 F.2d 259 [35 AFTR 2d 75-1635] (5th Cir. 1975); First National Bank of Shreveport v. United States, 342 F.2d 415 [15 AFTR 2d 1317] (5th Cir. 1965); Guynn v. United States, 437 F.2d 1148 [27 AFTR 2d 71-1653] (4th Cir. 1971); Estate of Skinner v. United States, 316 F.2d 517 [11 AFTR 2d 1855] (3d Cir. 1963); Estate of McNichol v. Commissioner, 265 F.2d 667 [3 AFTR 2d 1838] (3d Cir.), cert. denied, 361 U.S. 829, 80 S.Ct. 78, 4 L.Ed.2d 71 (1959); Estate of Gilman, 65 T.C. 296 (1975). Those cases do not support the proposition that the creation of a §2036 retained interest may not arise solely by operation of law, but requires an act or omission of the donor. While the opinion of the Tax Court in Estate of Gutchess, 46 T.C. 554 (1966), gives some support to the proposition, the statutory homestead residence rights involved in that case were not the kind of retained interest at which §2036 was aimed. Had it been otherwise, it is doubtful the Tax Court would have used the language that it did. In any event, a thorough discussion here is not called for because the point does not control the outcome of this case. The taxpayers' community interest in the separate property of their wives not being 'the right to income from, the property' within the meaning of §2036(a)(1), it makes no difference whether or not that community interest was 'retained' 'under' the transfers."

Wyly's Estate was followed in Rev. Rul. 81-221, 1981-2 CB 178, in holding that gifts between Texas spouses will not implicate IRC Section 2036.

The Wyly's Estate court was dealing with a situation in which the taxpayer decedent had done all he could do to rid himself of the property and rights and powers in it. In other words, the settlor affected "in form and within the intendment of the parties the most complete conveyance possible." In a trust structure such is not the case because the settlor determined to put it in a trust, which creates the problem, and instead could have given it outright and relied on conservatorship law to protect minor or incompetent beneficiaries. The settlor could waive the power to modify or terminate the trust, assuming the law so permits. Or maybe the settlor could have created a trust authorizing and requiring the trustee to settle a second trust with specified terms so the settlor would not be a settlor with 338(1) or 411(a) powers.[13] So, therefore, a settlor transferring property to a trust did not part with the corpus "in form and within the intendment of the parties the most complete conveyance possible," because he could have avoided possessing the power by one means or another.

It has been asserted that since this income right retained as a matter of law is not includable in the gross estate of the donor spouse, that the Wyly's Estate case stands for the proposition that other rights retained as a matter of law (e.g., UTC Section 411(a) and Restatement (2nd) of Trusts Section 338(1) powers of settlors) are also not includable. The Texas community property situation is unique to only a couple of states at best, and the court just was just not going to find that this anemic income right was the kind of right to which Section 2036(a)(1) would apply. Therefore the breadth of the

[13] If there is such a thing as a Wyly's Estate defense to application of the estate tax strings to settlor powers derived under Restatement Second Section 338(1) or UTC Section 411(a), could not a state enact legislation to permit creation of an entity that would vest a donor to it with an unwaivable power to demand the property back or direct its distribution? Since the settlor had done all he could do to part with his rights when property is contributed to this novel juridical animal, then, under that reasoning, there would be no estate tax strings.

holding is likely limited to the specific facts. Furthermore, the fact pattern of the case is narrow, and a court could, without much difficulty, distinguish the case.

As mentioned in Part A in this discussion, the Seventh Circuit has held powers retained as a matter of law are within the reach of both IRC Sections 2036 and 2038. Prudowsky v. Commissioner, 55 TC 890 (1971), aff'd Per Curiam, 465 F.2d 62 (7th Cir. 1972). See also Hauptfuhrer's Estate v Comm'r, 9 TCM 974 (1950), aff'd 195 F.2d 458 (3d Cir. 1952). As a final caution, in the Tax Court has also unambiguously weighed in that the source of the retained right is of no consequence to application of Section 2036. In Castleberry v Comm'r, 68 TC 682 (1977), a regular decision in a reviewed case, the court so held, quoting Estate of McNichol v. Commissioner, 265 F.2d 667, 670 (3d Cir. 1959), *cert. denied*, 361 U.S. 829 (1959):

> "This [the concept that rights retained solely by virtue of state law are not retained for purposes of Section 2036(a)(1)] is too constricted an interpretation to place on the statute. The statute means only that the life interest must be retained in connection with or as an incident to the transfer."

Castleberry was reversed by the Fifth Circuit in Wyly's Estate discussed above. Excluding cases appealable to that circuit (and then maybe only if Texas community property law is involved), it remains clear precedent.

Death Benefit Cases. The other rationale for support of the position that a settlor's power to terminate or modify a trust in conjunction with others under UTC Section 411(a) or Second Restatement Section 338(1) does not increase estate tax risk emanates from the death benefit cases decided by the old US Court of Claims. (*See* Kramer v US, 406 F.2d 1363 (1959) and Tully v US, 528 F.2d 1401 (1976)). This belief may be whistling in the dark. The court concluded that the exercise of the power by an ostensible donor was merely speculative, because it required the 50% shareholder to persuade the other 50% shareholder to agree to a change in a contractual death benefit to a spouse. The court said it was not a power other than a "power of persuasion," which is not a 2036(a)(2) power. That is a slippery slide. It is also difficult to reconcile with Strangi II. That could be said of any power under 2036(a)(2) that requires consent of other parties, whether or not adverse. But these cases involved power held by shareholders of corporations (with different issues of fiduciary obligations), and not by settlors of trusts. Furthermore, by that reasoning, no settlor power that is exercisable in conjunction with others is immune from the analysis in the death benefit cases, because others must be "persuaded" in the same context. If the logic of these cases applies to trusts, it would therefore follow that the statutory language "[by the decedent] alone or in conjunction with any person" in both Sections 2036 and 2038 would have to be flat out ignored.

Clark Case. Clark v US, 209 F.Supp 895 (D.C. Co. 1962), concerned a decedent who transferred property outright to her husband. He made a will that on his death gave her a life estate interest in a trust funded at least in part with those assets. In short, the court found she was not the settlor, so the ruling that her power to modify the trust with adverse parties, her sons, was not within Section 2038 is no surprise. The court said "… [I]t is not possible to read a retained life estate into this kind of arrangement."

Bowgren Case. In Estate of Bowgren v. Comm'r, TC Memo 1995-447, Judge Tannenwald, for the Tax Court, held that a decedent's estate did not include any interest in an Illinois land trust because the court found that the settlor only retained distribution powers over the trust as a beneficiary, and no such powers as a settlor. In other words, it appears that the powers retained were no broader than the powers held by the decedent in Helmholz. The Tax Court stated near the end of the decision:

"We conclude that the only method by which the decedent could have terminated or modified the beneficial interests of the children was to act not by herself under the reserved power of direction but as a beneficiary with the unanimous consent of the children, i.e., all the other beneficiaries. Such a power is not a retained power under section 2036(a)(2), see Stephens, Maxfield, Lind & Calfee, Federal Estate and Gift Taxation 4-148 n.52 (6th ed. 1991), and is a power to which section 2038(a) does not apply, see sec. 20.2038-1(a)(2), Estate Tax Regs."

The case was reversed by the Seventh Circuit in Estate of Bowgren v. Comm'r, 105 F.3d 1156 (1997), finding that the decedent separately, and in addition to the power she possessed described above, "retained the power to direct the trustee to convey title to a separate trust and to designate whomever she pleased as the beneficiary." So, although the IRS had asked that the court also address the Tax Court's finding quoted above, the Court of Appeals declined, since it was not necessary to so do. Footnote 20 reads:

"Because we conclude that Mrs. Bowgren retained the power of direction specifically granted to her by name in the trust agreement, we need not reach the issue whether a power to direct the trustee held by the settlor in conjunction with all the beneficiaries would be sufficient to require that the value of the units be included in the gross estate."

D. FAVORABLE PRIVATE LETTER RULINGS

PLRs 200247037 and 200303016 are signs that the government may not assert that powers held by a settlor under Second Restatement Section 338(1) and UTC Section 411(a) are subject to the claws of IRC Sections 2036 and 2038.

PLR 200247037. In PLR 200247037 the government ruled that with respect to a trust in which a settlor is not a beneficiary, the settlor's petition with all the beneficiaries to request that a probate court modify the trust by creating separate trusts for each beneficiary will not result in inclusion in the settlor's estate under IRC Sections 2036 or 2038. However, it is not clear what is the effect of the ruling. There is no representation that the settlor is deceased, and it is not clear why such a ruling was requested and what would be accomplished by obtaining the ruling. There is no understandable analysis of the issue of application of IRC Section 2036. The analysis of IRC Section 2038 applicability is conclusory. The relevant ruling requested was limited as follows:

"The following rulings are requested:

"(1) Consent by [the settlor] to the Petition to modify Trust will not result in N having a power to alter, amend, revoke, or terminate Trust or result in N retaining a right with respect to Trust with the effect that would cause the Trust property to be includible in N's estate under § 2036 or 2038.

. . ."

The relevant ruling given was:

"Accordingly, we conclude that the consent by N to the Petition to modify Trust will not result in N having a power to alter, amend, revoke, or terminate Trust or result in N retaining a right with respect to Trust with the effect that would cause the Trust property to be includible in N's estate under § 2036 or 2038."

The ruling is that the act of consenting to change the terms of a trust as to the referenced probate proceeding will not result in inclusion in the gross estate of a living person of the property of the original trust. There are many unknowns pertaining to the ruling that are relevant to whether the ruling shows the government may be sympathetic to the idea that UTC Section 411(a) powers are nontaxable.

PLR 200303016. PLR 200303016 is stronger evidence that the government is not presently looking askance at Second Restatement Section 338(1) and UTC Section 411(a) type powers. The ruling focused on the merger of four trusts settled by the same individual. The settlor and all the beneficiaries (excluding unborns – whether or not conceived, which the ruling found were not "beneficially interested persons" whose consent is required under the applicable state law) proposed to agree to amend the trusts by merger pursuant to applicable state law. The amendment could be made in the form of a writing meeting the requirements of "recording a conveyance of real property," which presumably is affected without court involvement. One ruling requested was:

> The proposed amendments to the four trusts and the merger of the four trusts into one trust will not cause the value of any assets under the four trusts to be included in Trustor's gross estate under §§ 2033, 2035, 2036, 2038, 2041, and 2042.

However, the IRS gratuitously issued the following ruling:

> Trustor has not retained any interest in the property in the four trusts for purposes of § 2033. The amendments to the four trusts and the merger of the four trusts into one trust will not considered a transfer of an interest or a relinquishment of a power by Trustor for purposes of § 2035. Trustor has not retained, for his life, the right, either alone or in conjunction with any person, to designate who will possess or enjoy the property or income from the merged trust, within the meaning of § 2036. Trustor has not retained any power, either alone or in conjunction with another person, to alter, amend, revoke, or terminate the merged trust within the meaning of § 2038. Further, Trustor will not possess a general power of appointment as defined under § 2041 with respect to the merged trust. The merged trust, not the Trustor, will be the owner of the life insurance policies for purposes of § 2042. Additionally, Trustor has represented that he possesses no incidents of ownership in the policies, under § 2042. Accordingly, we conclude that the value of the property in the merged trust will not be includible in Trustor's gross estate under § 2033, 2035, 2036, 2038, 2041, or 2042.

The relevant portion of the ruling pertaining to IRC Sections 2036 and 2038 were limited to restating IRC Section 2036(a) and Section 2038(a)(1), and then concluding:

> Section 20.2038-1(a)(2) of the Estate Tax Regulations provides that § 2038 does not apply if the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law. Similarly, § 2038 does not apply to a power held solely by a person other than the decedent. However, if the decedent had an unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.

There was no analysis of Section 2036 in either ruling. There is only a recitation of the statute and portion of the regulations that deals with the right to "remove and discharge a trustee at any time and appoint himself as trustee." The same Senior Counsel authored both rulings within a two month period. That having been said, it cannot hurt to have these rulings available if the need arises.

E. GOING FOR A RULING

In early 2004 at least one Fellow of the American College of Trust and Estate Counsel indicated he will probably attempt to obtain a ruling from the government (perhaps a revenue ruling) that settlor powers under UTC Section 411(a) (and perhaps under Second Restatement Section 338(1) and Third Restatement Section 65(2)) are not subject to the estate tax string provisions. Such a ruling request might be the proverbial "kicking the sleeping dog." It seems difficult to believe the government will rule that if a parent creates an irrevocable trust for a child that the parent at any time, due to operation of law, can elect to be distributed to the child or returned to the parent with the child's consent, the trust will not be includable in the gross estate of the parent. Such is not the fact pattern of Helmholz. In any event none of this would necessarily settle the estate tax issues arising from the virtual representation provisions of UTC Sections 303 and 304 discussed above. But a favorable ruling, if obtained, could only help.

F. CONCLUSION AND LEGISLATIVE RECOMMENDATION

This discussion does not prove that an estate tax inclusion is a certitude under the UTC, but it presents a case that there is a realistic possibility that adverse tax consequences may occur to estates of settlors that are both: (i) unique to the Uniform Trust Code and (ii) not unique but exposed by it. What began as an interesting issue evolved (or maybe degenerated) into deeper thought, peeling off layer after layer of the onion and digging into tax and trust law and each of their respective historical development. Even at that the constitutional issues are only touched upon.

Until such time as it is established that the estate tax concern is thoroughly discredited, then, whether or not the UTC is enacted in any particular jurisdiction, each jurisdiction should consider the following proposed legislation:

> (i) Confirm that a settlor may irrevocably waive the power to consent to modification or termination provided by UTC Section 411(a) and Second Restatement Section 338(1).[14] [15] [16]
>
> (ii) Retroactively eliminate the power of a settlor with respect to a trust that became irrevocable prior to such legislation, if it is established that a principal purpose of the trust was to avoid inclusion of its property in the gross estate of the settlor for purposes of federal estate taxation.[17] [18] [19]

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[14] Of all the states, apparently only settlors of trusts governed by Louisiana trust law do not have this power. La.R.S. Section 9:2028.

[15] Is it enough to permit sophisticated estate planners to navigate the estate tax labyrinth by means of drafting waivers of subtle yet critical powers? Legislation could provide that statements of a settlor indicating an intent to cause a trust to become irrevocable will cause automatic waivers of such powers, except to the extent expressly provided otherwise in the trust instrument.

[16] Another proposed alternative is to take the opposite tack and absolutely confirm that the power is unwaivable. The approach banks on the efficacy of the "Wyly's Estate defense" described above in the part of this discussion entitled "**Community Property Cases.**" This Hail Mary may be an all or none proposition. It might protect everybody, or it might fail completely. If it works, then settlors can continue to have their cake and eat it, too - have exclusion, and but continue retain a joint power to modify. But without a revenue ruling blessing this legislation, it seems unnecessarily risky when there is a road out of the fog.

EXHIBIT "A"

CAN A SETTLOR DRAFT AROUND UTC SECTION 411(a)?

Which UTC Section trumps the other? Section 411(a) or Section 105(b)? The UTC, on its face, is ambiguous as respects this issue.

UTC Section 105(b) provides that the terms of the trust are to prevail over the UTC. Therefore, if a provision of the trust states that "the Settlor has no power to alter, revoke, amend or terminate the trust," then the settlor cannot agree to so do, alone or in conjunction with anyone.[20] [21]

UTC Section 411(a) provides that the settlor and the beneficiaries can modify or terminate the trust, regardless of whether a material purpose of the trust is frustrated.

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[17] The statutory banishment of the power is preferable to waiver of the power by a settlor for the reason that there should be no three year survival requirement to avoid estate tax exclusion under IRC Section 2035 and 2038(a)(1). This is so because the settlor will apparently not have "relinquished" the power. Revenue Procedure 94-44, in Section 4.02, held that Florida's legislative "curtailment" of a beneficiary's withdrawal power to an ascertainable standard ("health, education, maintenance and support") was not a "lapse" of the power under IRC Sections 2041(b)(2) and 2514(e). So there is no "release" of the power that could activate the 3-year rule, in spite of the fact that the statute permitted "all parties in interest" to elect out.

[18] Some suggested retroactivity should be limited to requiring a court order to exercise the power. A variant of this approach is taken in an optional provision added in the 2004 Amendments to the Model UTC that seems to permit (but not require) the settlor and the beneficiaries to command an order, but only to trusts becoming irrevocable after enactment (in optional last sentence to UTC Section 411(a)). As discussed in Part A of this outline, the concern is whether merely permitting or requiring a perfunctory proceeding is enough of an impediment that will successfully negate application of the estate tax string provisions.

[19] An issue in some minds (but dismissed as extremely weak by others) is whether such a retroactive provision causes a denial of due process because a settlor is "… deprived of … property without due process of law…" proscribed by the Fifth Amendment, applied to the states through the Fourteenth Amendment. State constitutional law may also restrict such legislation and should be examined (ex: Arizona Constitution, Article 2, Section 4). If constitutionality is a serious issue, the provision could be drafted to give the settlor, with the consent of the beneficiaries, of an existing irrevocable trust the ability for a limited period of time after enactment to elect out of the clause, in order to mitigate the risk of constitutional infirmity. However, does the presence of such an opt-out power to put the settlor in the position of relinquishing the power if he fails to exercise it, thereby implicating the three year survival requirement discussed in footnote 16? Rev. Proc. 94-44, also discussed in footnote 16, ruled otherwise with respect to similar situation. Rev. Proc. 94-44 involved a legislative curtailment of a right of a trustee to directly benefit himself (arguably a more obvious deprivation), but permitted "all parties in interest" to elect out. The Service found no lapse of the power, and no taxable release. (The persons who could permit election out are essentially the same group described in UTC Section 411(a) and Second Restatement Section 338(1).) Note that model UTC Section 814(b)(1) contains a HEMS standard curtailment clause similar to the Florida statute discussed in Rev. Proc. 94-44, but does not have an opt-out right when applied retroactively (as is generally the case with the UTC).

[20] Such provision may be a material purpose of the trust or may further a material purpose of the trust. But the issue of materiality is not relevant in answering the above question.

[21] UTC Section 105(b)(4) prohibits the trust terms from abrogating (and, perhaps, from enhancing) the power of a court, and does not prevent trust terms from affecting the power of settlors and beneficiaries to modify or terminate a trust. This clause also does not affect the analysis in answering the question.

The comment to UTC Section 411 provides that first sentence of Section 411(a) was added to confirm that the settlor and beneficiaries may modify or terminate the trust, regardless of the purpose of the trust. The power of modification presumably includes the power of revocation. It follows, then, that Section 411(a) should apply to permit the settlor and beneficiaries to modify or terminate a trust, notwithstanding anything that would be set forth in the terms of the trust instrument. If so, it also logically follows that Section 411(a) prevails over Section 105(b).

The issue is then whether the settlor can independently irrevocably waive such a power, regardless of which section controls. If so, then where and how? Can the Settlor waive the power in the trust document? If the settlor cannot waive the power in the trust document, then the settlor should also be unable to waive it thereafter. It makes little sense to deny a settlor a waiver power if seconds later it could be validly exercised in another document. The 2004 Amendments to the Model UTC do not address this issue.

See EXHIBIT "B" for relevant text of the UTC and the comments

EXHIBIT "B"

SELECTED MODEL UTC SECTIONS

SECTION 105. DEFAULT AND MANDATORY RULES.

"(a) Except as otherwise provided in the terms of the trust, this [Code] governs the duties and powers of a trustee, relations among trustees, and the rights and interests of a beneficiary.

(b) The terms of a trust prevail over any provision of this [Code] except:

(1) the requirements for creating a trust;

(2) the duty of a trustee to act in good faith and in accordance with the purposes of the trust;

(3) the requirement that a trust and its terms be for the benefit of its beneficiaries, and that the trust have a purpose that is lawful, not contrary to public policy, and possible to achieve;

(4) the power of the court to modify or terminate a trust under Sections 410 through 416;

. . ."

Section 106 and selected Comment to Section 106:

"SECTION 106. COMMON LAW OF TRUSTS; PRINCIPLES OF EQUITY. The common law of trusts and principles of equity supplement this [Code], except to the extent modified by this [Code] or another statute of this State.

Comment

"The Uniform Trust Code codifies those portions of the law of express trusts that are most amenable to codification. The Code is supplemented by the common law of trusts, including principles of equity, particularly as articulated in the Restatement of Trusts, Restatement (Third) of Property: Wills and Other Donative Transfers, and the Restatement of Restitution. The common law of trusts is not static but includes the contemporary and evolving rules of decision developed by the courts in exercise of their power to adapt the law to new situations and changing conditions. It also includes the traditional and broad equitable jurisdiction of the court, which the Code in no way restricts.

. . ."

SECTION 411 (with 2004 Amendments). MODIFICATION OR TERMINATION OF NONCHARITABLE IRREVOCABLE TRUST BY CONSENT.

" (a) [A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.] [If upon petition the court finds that the settlor and all beneficiaries consent to the modification or termination of an irrevocable trust, the court shall enter an order approving the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust.] …"[22]

[22] A later iteration of the Model UTC was made in August 2004. NCCUSL's patch to attempt to address the estate tax concerns raised in earlier versions of this outline is to make Section 411(a) completely optional. But, as discussed above, that may not be enough to avoid possible application of the estate tax string provisions. Model UTC Section 106 confirms the application of common law except to the extent inconsistent with the UTC. Second Restatement of Trusts Section 338(1) is assumed to be the common law, and therefore "…

First final draft Comment to Section 411(a) language above:

"Subsection (a), which is based on Restatement (Second) of Trusts § 338 (1959), permits termination upon the joint action of the settlor and beneficiaries. While the beneficiaries alone cannot terminate a trust unless continuation of the trust is no longer necessary to achieve the settlor's material purposes in creating the trust, such a finding is not required if the settlor also consents. No finding is required because all parties with a possible interest in the trust's continuation, both the settlor and beneficiaries, are agreed there is no further need for the trust."

Current Comment (as of February 2003 - not reflecting changes made by 2004 Amendments) to Section 411, including the subsection (a) language above:

"This section describes the circumstances in which termination or modification of a noncharitable irrevocable trust may be compelled by the beneficiaries, with or without the concurrence of the settlor. For provisions governing modification or termination of trusts without the need to seek beneficiary consent, see Sections 412 (modification or termination due to unanticipated circumstances or inability to administer trust effectively), 414 (termination or modification of uneconomic noncharitable trust), and 416 (modification to achieve settlor's tax objectives). If the trust is revocable by the settlor, the method of revocation specified in Section 602 applies.

"Subsection (a) states the test for termination or modification by the beneficiaries with the concurrence of the settlor. Subsection (b) states the test for termination or modification by unanimous consent of the beneficiaries without the concurrence of the settlor. The rules on trust termination in Subsections (a)-(b) carries forward the *Claflin* rule, first stated in the famous case of *Claflin v. Claflin*, 20 N.E. 454 (Mass. 1889). Subsection (c) addresses the effect of a spendthrift provision. Subsection (d) directs how the trust property is to be distributed following a termination under either subsection (a) or (b). Subsection (e) creates a procedure for judicial approval of a proposed termination or modification when the consent of less than all of the beneficiaries is available.

"Under this section, a trust may be modified or terminated over a trustee's objection. However, pursuant to Section 410, the trustee has standing to object to a proposed termination or modification.

"The settlor's right to join the beneficiaries in terminating or modifying a trust under this section does not rise to the level of a taxable power. *See* Treas. Reg. Section 20.2038-1(a)(2). No gift tax consequences result from a termination as long as the beneficiaries agree to distribute the trust property in accordance with the value of their proportionate interests.

"The provisions of Article 3 on representation, virtual representation and the appointment and approval of representatives appointed by the court apply to the determination of whether all beneficiaries have signified consent under this section. The authority to consent on behalf of another person, however, does not include authority to consent over the other person's objection. *See* Section 301(b). Regarding the persons who may consent on behalf of a beneficiary, see Sections 302 through

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supplements this [Code], except to the extent modified by this [Code] …". It is unlikely that complete omission of any discussion of this power in the UTC (if Section 411(a) is not adopted) would be seen to modify the power of a settlor to consent to modification or termination of an irrevocable trust. The best that can be said is that the latest amendment may cause the UTC to become neutral on the issue if section (a) is in fact omitted. NCCUSL further provides optional language if Section 411(a) is retained to require a court to order modification or termination if petitioned to so do and the settlor and all beneficiaries agree. This provision again does not necessarily "modify" the existing common law right of such persons to modify or terminate the trust out of court.

305. A consent given by a representative is invalid to the extent there is a conflict of interest between the representative and the person represented. Given this limitation, virtual representation of a beneficiary's interest by another beneficiary pursuant to Section 304 will rarely be available in a trust termination case, although it should be routinely available in cases involving trust modification, such as a grant to the trustee of additional powers. If virtual or other form of representation is unavailable, Section 305 of the Code permits the court to appoint a representative who may give the necessary consent to the proposed modification or termination on behalf of the minor, incapacitated, unborn, or unascertained beneficiary**. The ability to use virtual and other forms of representation to consent on a beneficiary's behalf to a trust termination or modification has not traditionally been part of the law, although there are some notable exceptions. *[emphasis added]*** *Compare* Restatement (Second) Section 337(1) (1959) (beneficiary must not be under incapacity), *with Hatch v. Riggs National Bank*, 361 F.2d 559 (D.C. Cir. 1966) (guardian ad litem authorized to consent on beneficiary's behalf).

"Subsection (a) also addresses the authority of an agent, conservator, or guardian to act on a settlor's behalf. Consistent with Section 602 on revocation or modification of a revocable trust, the section assumes that a settlor, in granting an agent general authority, did not intend for the agent to have authority to consent to the termination or modification of a trust, authority that could be exercised to radically alter the settlor's estate plan. In order for an agent to validly consent to a termination or modification of the settlor's revocable trust, such authority must be expressly conveyed either in the power or in the terms of the trust.

"Subsection (a), however, does not impose restrictions on consent by a conservator or guardian, other than prohibiting such action if the settlor is represented by an agent. The section instead leaves the issue of a conservator's or guardian's authority to local law. Many conservatorship statutes recognize that termination or modification of the settlor's trust is a sufficiently important transaction that a conservator should first obtain the approval of the court supervising the conservatorship. *See, e.g.*, Unif. Probate Code Section 5-411(a)(4). Because the Uniform Trust Code uses the term "conservator" to refer to the person appointed by the court to manage an individual's property (*see* Section 103(4)), a guardian may act on behalf of a settlor under this section only if a conservator has not been appointed.

"Subsection (a) is similar to Restatement (Third) of Trusts Section 65(2) (Tentative Draft No. 3, approved 2001), and Restatement (Second) of Trusts Section 338(1) (1959), both of which permit termination upon joint action of the settlor and beneficiaries. Unlike termination by the beneficiaries alone under subsection (b), termination with the concurrence of the settlor does not require a finding that the trust no longer serves a material purpose. No finding of failure of material purpose is required because all parties with a possible interest in the trust's continuation, both the settlor and beneficiaries, agree there is no further need for the trust. Restatement Third goes further than subsection (b) of this section and Restatement Second, however, in also allowing the beneficiaries to compel termination of a trust that still serves a material purpose if the reasons for termination outweigh the continuing material purpose."

Section 304 and Comments to Section 304:

"SECTION 304. REPRESENTATION BY PERSON HAVING SUBSTANTIALLY IDENTICAL INTEREST. Unless otherwise represented, a minor, incapacitated, or unborn individual, or a person whose identity or location is unknown and not reasonably ascertainable, may be represented by and bound by another having a substantially identical interest with respect to the particular question or dispute, but only to the extent there is no conflict of interest between the representative and the person represented.

Comment

"This section authorizes a person with a substantially identically interest with respect to a particular question or dispute to represent and bind an otherwise unrepresented minor, incapacitated or unborn individual, or person whose location is unknown and not reasonably ascertainable. This section is derived from Section 1-403(2)(iii) of the Uniform Probate Code, but with several modifications. Unlike the UPC, this section does not expressly require that the representation be adequate, the drafters preferring to leave this issue to the courts. Furthermore, this section extends the doctrine of virtual representation to representation of minors and incapacitated individuals. Finally, this section does not apply to the extent there is a conflict of interest between the representative and the person represented.

"Restatement (First) of Property Sections 181 and 185 (1936) provide that virtual representation is inapplicable if the interest represented was not sufficiently protected. Representation is deemed sufficiently protective as long as it does not appear that the representative acted in hostility to the interest of the person represented. Restatement (First) of Property Section 185 (1936). Evidence of inactivity or lack of skill is material only to the extent it establishes such hostility. Restatement (First) of Property Section 185 cmt. b (1936).

"Typically, the interests of the representative and the person represented will be identical. A common example would be a trust providing for distribution to the settlor's children as a class, with an adult child being able to represent the interests of children who are either minors or unborn. Exact identity of interests is not required, only substantial identity with respect to the particular question or dispute. Whether such identity is present may depend on the nature of the interest. For example, a presumptive remaindermen may be able to represent alternative remaindermen with respect to approval of a trustee's report but not with respect to interpretation of the remainder provision or termination of the trust. Even if the beneficial interests of the representative and person represented are identical, representation is not allowed in the event of conflict of interest. The representative may have interests outside of the trust that are adverse to the interest of the person represented, such as a prior relationship with the trustee or other beneficiaries. *See* Restatement (First) of Property Section 185 cmt. d (1936)."