STATE TRUST LAW ISSUES TO PONDER IN AN ELDER LAW PRACTICE

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April 2017
Boston, MA

Certified by the National Elder Law Foundation as a Certified Elder Law Attorney; Council of Advanced Practitioners of National Academy of Elder Law Attorneys

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I. What we're doing here

Too often we elder and special needs law attorneys focus our legal analysis involving trusts on federal law, particularly with respect to availability of assets, transfer sanctions upon trust funding, the effect of distributions on trust beneficiaries, and the like.

We must never forget, however, that trusts are creatures of state law. State law, with limited exceptions, governs the creation, asset protection efficacy, administration and termination of trusts.

In fact, the application of state trust law can affect federal benefits. As we shall see, the thoughtless application of "boilerplate" trust provisions allowable under state law can yield disastrous results. Also, often state trust law provides a default "backstop" to the absence of various trust agreement provisions that may be elective and contrary to the default state law provision and which the trust scrivener is free to insert. The failure to address these situations will result in the state "default" provision, and the result may not be desirable.

The purpose of this outline is to provide a partial checklist of state law issues for further consideration in view of local law that applies to your practice. I cannot begin to discuss each in detail due to space and the details inherent in at least 51 jurisdictions. Further, there are no doubt a number of other state law issues that I have either overlooked or simply chose not to address.

My purpose here is to give you food for thought.

II. State Law Applicability

A. The Horrific *Doherty* Example

Congress has always intended that, with few exceptions, state law apply to all aspects of trusts under Medicaid and SSI. In fact, one of the most notorious and relatively recent cases is *Doherty v. Dir. Off. of Medicaid*[2] provides no binding, and very little persuasive, authority outside Massachusetts. Nevertheless, it provides an excellent legal template for a state agency to successfully mount a challenge to an irrevocable income only trust. Practitioners would be wise to heed the case carefully and note that much of the result turns on Massachusetts trust law.

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[2] (Mass. App. Ct., Essex, No. 08-P-939) (March 2009). In fact, Massachusetts may be on the east coast, but it is the Wild West when it comes to battling the state agency with respect to trusts. I highly commend Brian Barreira's blog at https://elderlaw.info. Brian is a Massachusetts elder law and estate planning attorney who has done a great job of holding the Massachusetts elder law office to account.

Facts: Muriel Doherty established an irrevocable trust naming her niece and nephew trustees. She reserved a lifetime income interest and the trust contained the usual admonition that under no conditions would any distributions of principal be made to her or on her behalf.

Unfortunately, the trust contained a number of boilerplate provisions allowable under Massachusetts law and common to many form trusts.[3]

1. The trustee had the right "in its sole discretion and notwithstanding any other provisions" to terminate the trust in the event the trust became too small for practical administration and distribute to the beneficiaries (in general terms – no specification of remainder beneficiaries). This alone could have decided the case.

2. The trustee had exclusive right to determine all allocations of principal and income.

3. The trust also contained unfortunate language describing the "unforeseeability" of Muriel's future needs and to accumulate principal "to the extent feasible."

4. Muriel retained a special power to appoint principal to any of Muriel's descendants or siblings.

5. She specifically retained a right to remain in the home, giving her, as the court observed, a veto power over any potential sale.

Law: The court mentioned that the trust was subject to the "post-1993 statutory scheme" (a nod to OBRA '93) and specified that its task was to determine whether any portion of the principal of this self-settled trust could "under any circumstances" be paid to or for the benefit of Muriel. But it all involved the application of Massachusetts law.

Held: The trust vehicle "considered as a whole" evidenced Muriel's intent that the trustees would invade the principal as necessary to insure her comfort. The court characterized the trust as a "remarkably fluid legal vehicle" structured to provide maximum flexibility to respond to Muriel's changing needs. Implicit (by mentioning the trustee's power to allocate between principal and income) was the conclusion that the trustees could distribute "principal" to Muriel simply by recharacterizing it as "income."

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[3] Relax, the various factors discussed by the court in *Doherty*, I believe, had a cumulative effect, so inclusion of a provision noted in *Doherty* does not necessarily doom the trust to Medicaid "availability" standards.

Lessons: Eliminate the right to terminate a small trust and distribute to "the" beneficiaries (specify who, other than the grantor, takes). Lock the trustee into definitions of principal and income. Avoid inter vivos special powers of appointment (stick with testamentary powers). Allow the beneficiary to remain in the home at the sufferance of the trustee or consider subjecting the beneficiary to an occupancy agreement (perhaps obligating the beneficiary to cover carrying costs of the residence). And by all means avoid recitals describing the grantor's future or current needs!

To emphasize one of the critical points, many scriveners employing trust advisor/trust protector language grant the advisor/protector authority to terminate the trust under certain circumstances and distribute trust assets to some or all beneficiaries, but *care should be taken to insure the grantor is not a member of the class of beneficiaries eligible for a potential distribution*.

As will be discussed further below, "default" provisions of state trust law regarding terminations can pose similar risks.[4]

Conclusion: On the bright side, the court said that it had "no doubt that self-settled, irrevocable trusts may, if so structured, so insulate assets that those assets will be deemed unavailable to the settlor."

Again, the Doherty "take-away" for attorneys outside of Massachusetts is the application of state law to a less-than-well-thought-out trust could yield similar results in almost any state. We'll look at some of those considerations below.

B. Pre-OBRA '93

Prior to passage of OBRA '86[5] the general Medicaid rule with regard to trusts under old U.S.C. § 1396a(a)(17)(B) was that state law controlled as it would with respect to any other debtor-creditor relationship. In most states the general rule is that creditors may reach the assets in a self-settled trust (grantor is also a beneficiary) to the extent that distributions could be made for the benefit of the grantor. The Uniform Trust Code[6] ("UTC"), with some version effective in about a third of the states, adopted this same approach in section 505(a)(2).

The rules offered a common planning strategy that involved establishing a self-settled irrevocable trust. Distributions of principal to the settlor were prohibited and distributions of

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[4] *See* discussion of trust terminations below at section V.

[5] Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 2070 ("OBRA 86").

[6] Adopted by 31 states as of the date of this Outline.

income were optional during the relatively brief penalty period of 30 months. Thereafter, pursuant to 42 U.S.C. § 1396a(a)(17)(B) the trust assets were not deemed available.

In 1986, Congress tightened the trust rules by defining a Medicaid Qualifying Trust (MQT) under new 42 USC § 1396a(k).[7] The 1986 rule provided that an MQT was a self-settled trust in which the settlor retained any beneficial interest. The assets in an MQT would be deemed available to the extent that the trustee, exercising maximum discretion, could make a distribution to the settlor. Notwithstanding the term "Medicaid Qualifying" the effect of an MQT was to disqualify the settlor. There was still some wriggle room. A trust could be drafted to remove trustee discretion as soon as some condition applied, perhaps a move to a nursing home. Thus the term "Trigger Trust."

C. Post-OBRA '93

In an effort to further tighten the trust rules, OBRA '93 repealed the existing 42 USC § 1396a(k) and provided the now familiar rules under 42 USC § 1396p(d). Without consideration of the (d)(4) exceptions regarding special needs trusts, the current rules provide that state trust law considerations involving the purposes for creating the trust, the existence of any trustee discretion, the existence of restrictions on the trustee or any exculpatory clauses are irrelevant. Rather, if there are any circumstances whatsoever under which the trustee could make a distribution, the trust portion (including the entire trust) from which the distribution could be made will be deemed available. Further, any portion not available will be considered for a possible transfer of assets sanction under 42 USC § 1396p(c).

In any event, however, these are the only provisions under Title 42 of the United States Code in which state law could be abrogated.

III. Trust Creation

State law will control whether an effective trust has been established in the first place.

A. Capacity

Under the UTC, the capacity required to execute a revocable trust is the same as testamentary capacity.[8] Given that revocable trusts are often (if not usually) an estate planning substitute for a will, that is a commonsense approach.

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[7] OBRA 86 § 9435(c).

[8] UTC § 402, Official Comment, ¶ 2.

The capacity required for the execution of an irrevocable trust, according to the UTC, is that required to transfer property free of trust, which is generally thought to be a higher standard than testamentary capacity. Transferring property "free of trust" would involve either a gift or a contract, and in either case, the standards are usually similar. For example, the generally accepted standard for a gift is whether the donor understood the nature, scope, and effect of the gift.[9] A common standard for contractual capacity is whether the individual has the capacity to understand the nature and effects of the agreement.[10] These standards also make sense since gifts and contracts have an immediate impact on the donor, as opposed to a testamentary disposition that will have no impact on the testator.

It may be that contracts and gifts by an incapacitated individual are deemed, in your jurisdiction, to be merely voidable as opposed to void *ab initio*. In which case, the difficult decision to proceed in a marginal elder law case might hinge on the likelihood of potential plaintiffs in a later action, the negative outcomes (and positive good) that a trust might accomplish, and how closely a trust aligns with earlier estate planning activities. In any event, that is a difficult decision for the practitioner to navigate.

B. Creation by Agent

Incapacitated clients in an elder and special needs law practice are not unusual and often some sort of trust settled on the client's behalf might be a sound tactic. The question is whether an agent acting on behalf of the client has the authority to establish the trust.

UTC § 402(a)(1), as discussed above, refers to the settlor's capacity to create a trust and is silent with respect to whether others, acting on behalf of an incapacitated settlor, may create a trust.[11]

On the other hand, the Uniform Power of Attorney Act[12] ("UPOAA") § 201(a)(1) grants an attorney in fact the authority to "create, amend, revoke, or terminate an inter vivos trust" if

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[9] *See* Lawrence A. Frolik and Mary F. Radford, "Sufficient" Capacity: The Contrasting Capacity Requirements for Different Documents, 2 NAELA J. 303, 313 (2006) (hereinafter "Frolik and Radford") citing *Lamb v. Perry*, 86 S.E. 179, 183 (1915). The Frolik and Radford article is an excellent article for an overview of this topic.

[10] Frolik and Radford at 315, citing 17A C.J.S. *Contracts* § 143 (2005).

[11] It is interesting that UTC § 602(e) grants an attorney in fact the authority to revoke or amend or completely distribute a revocable trust if the POA contains an express grant to do so (discussed further below). North Carolina goes further and its version of UTC § 602(e) (currently codified at NCGS § 36C-6-602.1) authorizes an agent to create a revocable trust on the principal's behalf as long as it does not "alter the designation of beneficiaries to receive property on the settlor's death under the settlor's existing estate plan."

[12] Adopted by 26 states, pending in three others, as of the date of this Outline.

the power of attorney “expressly grants the agent the authority, and the power to do so has not otherwise been prohibited elsewhere.

According to the Official Comment to UPOAA § 201(a)(1) a general grant of authority under a POA is insufficient; the grant of authority to create a trust (among other powers) must be specific.

A number of interesting cases discuss this issue. One in particular is the 2015 Kentucky case of *Dishman v. Dougherty*.[13] The issue in *Dishman* was whether a grant of authority under a power of attorney expressly authorized the creation of an irrevocable trust and authorized the transfer of real property to that trust by the attorney in fact. The power of attorney authorized the agent to:

> Convey any real or personal property to the Trustee of any trust agreement between me and said Trustee and entered into either before or after the date of this instrument;

After a lengthy discussion that concluded any such authority must be strictly construed, the Kentucky Court of Appeals held that the language merely authorized a conveyance of real property to a trust that *the principal* (not the agent) may have established either before or after the principal executed his power of attorney.[14]

It seems clear that in those states that have adopted both the UTC and the UPOAA that a POA granting an attorney in fact the express authority to create and fund a trust on behalf of the principal ought to be sufficient to allow such a transaction. Although the UTC is silent as to the authority of an agent to create an irrevocable trust, the UPOAA grant of authority should be sufficient (to find otherwise, that UTC silence overrides UPOAA, would render the UPOAA provision void).

A careful review of the law by practitioners in those states that have enacted the UTC (silent, unless the state has amended it otherwise) but not the UPOAA would be in order. Some states have enacted other non-UPOAA legislation specifically authorizing the creation of trusts.

In any event, an elder and special needs law attorney drafting trusts should have a clear understanding of where his or her state stands on this issue.

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[13] *Dishman v. Dougherty*, Nos. 2013-CA-000558-MR, 2013-CA-000559-MR (Ky. App. 2015).

[14] *Id.* at 35.

In the event that a trust must be established and local law does not favor the establishment by an attorney in fact, check local law for some sort of version (or analogy) of UTC § 403 ("Trusts Created in Other Jurisdictions"). A trust is valid if created in another jurisdiction and the trust is valid in that jurisdiction. It may be possible that the state "just across the river" has more accommodating law applicable to this situation. Of course, according to UTC § 403 there must be some sort of nexus to the other state. Those connections are expressed, in the alternatives, as the state in which the trust was executed, in which the trustee is domiciled, in which the settlor was domiciled, or in which "any trust property was located." Depending upon the particular facts, it may be a rather simple process to create a trust in a friendlier jurisdiction.

IV. Asset Protection

A. Spendthrift Clause

Occasionally I review a trust document that does not contain a valid spendthrift clause. In the event of a third party trust, the absence of a spendthrift clause could likely create difficulties for an SSI beneficiary.

Pursuant to the Program Operation Manual System (POMS) SI 01120.200D.1.a, principal will be available if a beneficiary has the right (i) to revoke or terminate the trust and use the funds to "meet his food and shelter needs," (ii) to direct the use of trust principal for his support and maintenance under the trust terms, or (iii) assign or sell his beneficial interest absent a valid spendthrift clause.[15] Similarly, D.2. rather succinctly says:

> If an individual does not have the legal authority to revoke or terminate the trust or to direct the use of the trust assets for his or her own support and maintenance, the trust principal **is not** the individual's resource for SSI purposes.
>
> The revocability of a trust and the ability to direct the use of the trust principal depend on the terms of the trust agreement and/or on State law. If a trust is irrevocable by its terms and under State law and cannot be used by an individual for support and maintenance (*e.g.,* it contains a valid spendthrift clause . . .), it **is not** a resource.

Insure that trusts contain valid spendthrift clauses.

[15] Ammunition in case a client ever asks you why you put that "boilerplate" spendthrift clause in the trust.

B. Fraudulent Conveyance

All states have some sort of fraudulent conveyance statute, the essence of which is that any transfer made (i) that leaves the transferor insolvent, and (ii) with the intention to hinder, delay, or defraud creditors may be set aside by creditors (in other words, the creditors may reach the transferred assets in the hands of the transferees).

The issue is whether funding an irrevocable trust could be set aside as a fraudulent conveyance.

I can find no instance of a state Medicaid program attacking a transfer on fraudulent conveyance grounds, and such an attack would, in my opinion, be subject to collateral attack. The federal statutes[16] contain intricate rules with respect to the types of transfers that are subject to program sanctions and those that are allowed. The states have carried those rules over into their individual programs, and to then have a state attack such an otherwise allowable transfer on fraudulent conveyance basis would seem rather farfetched.

On the other hand, private creditors certainly stand differently and have successfully asserted fraudulence conveyance claims under state law theories in factual situations in which Medicaid planning was evident.

For example, a transfer of assets may leave the transferor insolvent and also render the transferor ineligible for Medicaid during a transfer penalty period. If during that period the transferor incurs expenses (perhaps a nursing home bill), the transferees very well may be liable to the nursing home.[17]

Bottom line: When funding an irrevocable trust, either insure that the transferor is going to be eligible for Medicaid or provide some financing mechanism until the transferor is eligible for Medicaid.

V. Administration

Overlooked by many, state law will provide many "default" settings that apply if not provided for to the contrary in a trust agreement. Unfortunately, many of these state law provisions are overlooked, misunderstood or simply incorporated by reference in the seldom read "boilerplate" of an agreement.

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[16] 42 USC 1396p(c) and (d), for example.

[17] *See, e.g., Chapin home for the Aging v. Heather,* No. 25327/2010, N.Y. Sup. Ct. (April 23, 2013) ($300,000 recovery); *Lifesphere v. Sahnd,* 179 Ohio App. 3d 685 (2008) (recovery of residence by nursing home).

A. Principal & Income Act

One of the items that contributed to the perfect storm of *Doherty* (discussed above) was the trustee's ability to make determinations of principal and income without regard to the Massachusetts principal and income act (every state has one). Although arguments could be advanced that the trustee's right to do so was not unfettered given that he had a fiduciary obligation to act impartially among the current and remainder beneficiaries, the judge reasoned that it would be a simple matter for the trustee to classify "principal" as income and distribute it to Mrs. Doherty as part of her retained income right.

Buried within the fiduciary powers boilerplate of many trust agreements is the trustee authority to make determinations of principal and income. While this is not an issue with respect to a third party trust, in a self-settled trust context (*e.g.*, a typical intentionally defective income only trust[18]) recall that Medicaid rule of 42 U.S.C. § 1396p(d)(3)(B)(i) applies to make any trust portion that could "under any circumstances" be distributed an available resource.[19]

Accordingly, out of an abundance of caution you may wish to avoid giving the trustee the authority to make principal and income determinations without reference to the state principal and income act.

B. Prudent Investor (Diversification)

The general duty to diversify trust investments is a hallmark of risk avoidance. Every state has some version of this rule, the uniform act version of which is Uniform Prudent Investor Act ("UPrIA"[20]) § 3.

The third paragraph of the Comments under UPrIA § 3 gives some maneuver room:

> Circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an under diversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.

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[18] A term you should cherish if you enjoy acronyms

[19] 42 U.S.C. § 1382b(e)(3)(B) applies the same rule in the SSI context.

[20] That is not a typo; I prefer to abbreviate the act as shown to avoid confusion with the Uniform Principal and Income Act (also occasionally abbreviated as "UPIA").

A trustee of a trust holding some sort of legacy property (say, a farm or a beach house) may not, however, take much solace in that comment when the various family members begin quarreling.

The safer course for the drafting attorney to take is to expressly relieve the trustee of the duty to diversify, either generally or with regard to a specific asset, if the settlor intends the trust to hold some form of legacy property.

C. Decanting

The Uniform Trust Decanting Act ("UTDA") allows a great deal of flexibility in responding to changed circumstances or perhaps other trust design errors by allowing the creation of a second trust that does not substantially alter the beneficial interests of the beneficiaries of the first trust and rolling the assets of the first trust to the second. The UTDA has been adopted in Colorado and New Mexico only, and has been introduced in Nevada, Illinois, and Virginia). Other states have added decanting provisions as an additional section to trustee powers.[21]

While every decanting statute I have examined contains the general rule that beneficial interests cannot be substantially altered (for example, expanding trustee discretion in a second trust beyond an ascertainable standard contained in the first trust), there may be exceptions to the general rule.

UTDA § 13 specifically addresses special needs situations and could be an extremely useful tool in the event of changed circumstances. In fact, the official comment to USDA § 13 ("*Furtherance of Purposes of Trust*") discusses the hypothetical case of a first trust having been designed without any anticipation of the beneficiary's future incapacity, and a second trust being designed with an altered distribution standard to allow the beneficiary to qualify for public benefits.

D. Situs Change

UTC § 108 ("Principal Place of Administration") imposes an affirmative fiduciary duty "to administer the trust at a place appropriate to its purposes, its administration, and the interests of its beneficiaries." Most states, even non-UTC states, have some sort of procedure with respect to change of situs. You should be familiar with yours.

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[21] *E.g.*, North Carolina added a decanting section immediately after the trustee powers sections of its version of the UTC. NCGS § 36C-8-816.1.

As has been illustrated in other areas of this outline, there are any number of reasons to consider moving a trust's administrative situs to a state with laws more accommodating to the purposes of the trust. Among them may be:

- Reduction or elimination of state fiduciary income tax.
- Availing the parties of a more favorable decanting statute.
- Greater creditor protection features (particularly with respect to a self-settled trust).
- Minimizing administrative costs.
- A desire to convert to a unitrust (if the original state has no unitrust conversion feature).
- Access to streamlined trust modification or termination procedures.

Note that UTC § 108(d) provides a number of administrative formalities to initiate a change of situs. Further, under UTC § 108(e) a beneficiary can derail the whole process by filing a timely objection to the situs change.

VI. Tax Issues

With respect to taxation, the biggest intersection of state and federal law pertains to the taxation of capital gains at either the trust level or in the hands of the beneficiaries.

A. The Problem

The capital gains tax rate for any person or trust in the 39.6% ordinary income tax bracket is 20% (as opposed to 15% or less for those in lower brackets). If the gain is investment income (capital gains invariably are for trusts) a surtax of 3.8% applies to trusts in the 39.6% bracket.[22] The difference between a trust and an individual is that a trust reaches the 39.6% bracket at just $12,500 compared to an individual at $416,700.

The sale of a trust asset represents a mere conversion of a portion of trust principal from a tangible asset into fungible cash. The proceeds remain allocated to principal. To do otherwise would slight the mythical remainder beneficiary anticipating the benefits of an eventual distribution of trust principal.

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[22] The surtax applies to individuals with modified adjusted gross income over $200,000. The surtax was a component of the Affordable Care Act, which faces an uncertain future. In any event, Congress could elect to repeal the ACA but retain the surtax as a subtle way of raising the capital gains tax.

Both state laws governing the allocations of principal and income and federal tax law track this notion. Capital gains are part of principal and should stay in the trust. Income distributed to the beneficiaries is taxed to the beneficiaries.

The tax concept of distributable net income (DNI) applies to determine what items of trust income, deduction, and credit should be deemed to be distributable to the income beneficiaries, and what of those items should be deemed to remain in trust (presumably to impact distributions to remainder beneficiaries). Taxable amounts of DNI distributed to beneficiaries are taxed to the beneficiaries; taxable amounts of DNI not distributed to beneficiaries, as well as taxable income not included in DNI, are taxed to the trust.

Tax and state law generally allocate capital gains to principal and exclude it from DNI. The result is a "default" setting in which capital gains are trapped in the trust to be taxed at higher rates. There are, however, a number of regulatory exceptions. A few of those hinge on state law.

B. The Fix

2004 tax regulations[23] provide exceptions to allow for the inclusion of capital gains in DNI. A thorough discussion of the entire (and dense) Regulation is beyond the scope of this Outline.[24] Nevertheless, a thoughtfully draft trust (or perhaps thoughtlessly drafted, but with a lucky scrivener) combined with helpful state law may assist.

The first, and threshold, question is whether a trust document allows the trustee to make discretionary distributions of principal. If it does not, then there is not much to be done; capital gains will be taxed in the trust. On the other hand, if the power exists there may be some help under state law.

1. Power to Distribute In-Kind

If a capital asset is about to be sold, determine the advisability of having the trustee simply distribute the asset to the beneficiaries and have the sale take place at the beneficiary level. The trust document may give the trustee discretionary authority to distribute principal in-kind. If it does not, however, check your state's trust code.

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[23] Definition of Income for Trust Purposes, 69 Fed. Reg. 12, 18 (Jan. 2, 2004) (codified at Treas. Reg. § 1.643(a)-3) (hereinafter the "Regulation")).

[24] For a thorough discussion and analysis, *see* Jonathan G. Blattmachr & Mitchell M. Gans, *The Final 'Income' Regulations: Their Meaning and Importance,* 103 Tax Notes 891 (2004) and John Goldsbury, *Dealing with the 23.8% tax on trust capital gains* (2014) at http://bit.ly/2eVUnyR.

Like many states, the North Carolina General Statutes provide a laundry list of general fiduciary powers that may be incorporated by mere reference. Many trust documents (carelessly, in my opinion) incorporate powers by reference. Buried in the North Carolina statutory list is the authority "[t]o make distribution of capital assets of the estate or trust in kind or in cash, or partially in kind and partially in cash . . . ."[25] Your state may have a similar provision.

Also, check your state's trust code. For example, UTC § 816(22) is not helpful, but the North Carolina version grants a trustee specific power "to distribute trust property in kind or in cash, or partially in kind and partially in cash, in divided or undivided interests."[26]

2. Power to Allocate Capital Gains to Discretionary Principal Distributions

It may be possible specifically to allocate capital gains to discretionary distributions of trust principal that would be carried out for taxation in the hands of beneficiaries. You will need that authority granted by the trust agreement or by state law.

The Regulation says that a trustee acting in a reasonable and impartial manner in accordance with either state law or a trust provision may include capital gain otherwise allocated to principal as part of DNI as long as the trustee includes the capital gain in DNI consistently over the years.[27] The key word is "consistently."

Regulation Examples 1 and 2 illustrate the consistency requirement. In both examples, a trustee has authority to deem discretionary distributions of principal to be made first from capital gains. In Example 1, during the first year of the trust trustee makes a discretionary distribution of principal but fails to exercise the deeming power. In Example 2 the trustee deems the distribution of principal to have come first from capital gains.[28] In both cases, the trustee was locked in. Pick your poison.

Check the trust's back Forms 1041. Perhaps the trust you are dealing with never had capital gains. For example, funding a trust with real property and never realizing any capital gains is not unusual, particularly in the elder law context.

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[25] NCGS § 32-27(27) ("Incorporation by Reference").

[26] NCGS § 37C-8-816(22).

[27] Treas. Reg. § 1.643(a)-3(b)(2).

[28] The trustee demonstrates this election by including the gains in DNI on the trust's Form 1041 and the beneficiary's K-1.

If that is the case with your particular matter, there was never a consistent practice established. If the trustee is willing to commit to deeming any future principal distributions to be from capital gains, and if she is duly authorized, then she could distribute the gain from the sale of a capital asset and include it in DNI.

Specific trust agreement authority to include capital gains in DNI is the basis of both Regulation examples. If the trust agreement provides no such authority, perhaps your state trust code does. A plain reading of the Regulation seems to allow this.[29]

The UTC is not helpful, but a number of states added language to their versions of the UTC to provide the discretionary power. North Carolina and Alaska are examples.[30] If your state does not and the power is critical to a client, you could consider moving trust situs to one of these states[31] or another friendlier state.

VII. Termination

A. Early Termination of an Irrevocable Trust

The UTC provides a mechanism for modifying or terminating a trust that, in some cases, can be quite flexible and avoid the participation of a court. In spite of this wonderful level of flexibility (which I have used to achieve good results) the provision poses an issue that concerns me in the elder and special needs law context, discussed further below.

1. The Mechanics

UTC § 411(a) provides two alternatives for consideration of state enactment. The first alternative allows for trust modification or termination upon the consent of the settlor and all beneficiaries even if the action is inconsistent with a material trust purpose. The second option provides for modification or termination upon petition to a court, but confines the court to determining whether all of settlor and beneficiaries consent; beyond that finding, the court must issue an order approving the proposed action.

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[29] The introductory paragraph refers to authority granted by "local law ***or*** by the governing instrument." Treas. Reg. § 1.643(a)-3(b) (emphasis added).

[30] NCGS § 36C-8-816(16) ("Exercise elections with respect to federal, state, and local taxes including, but not limited to, considering discretionary distributions to a beneficiary as being made from capital gains realized during the year"); Alaska Stat. § 13.36.109.

[31] We'd love to see you in North Carolina!

UTC § 411(b) allows for termination of a trust upon the consent of all beneficiaries (perhaps the settlor is now deceased) if a court concludes that trust continuance is not necessary to achieve a material purpose of the trust. As of the date of the preparation of this Outline, I am involved in a potential testamentary trust termination under the North Carolina version of this statute. A testamentary spendthrift trust for the benefit of a then rather dissolute child was funded when parent died 20 years ago. The child is now a paragon of responsibility, financially secure, and has no need for any protection. The child has, however, succeeded in making life miserable for the trustees, and about all that anyone can agree to is that this trust should be terminated as soon as possible.

Also worth noting is that an agent, if expressly authorized by the terms of a power of attorney, may exercise the settlor's rights with respect to the foregoing.

Finally, upon a trust termination under either subsections (a) or (b), the trust is to be distributed "as agreed by the beneficiaries." This provision poses a potential issue.

2. My Concern

Similar to some of the court's reasoning in *Doherty*, discussed above, and being mindful of the Medicaid rule of 42 U.S.C. § 1396p(d)(3)(B)(i) that renders any trust portion that could "under any circumstances" be distributed an available resource,[32] I am concerned that the UTC § 411(a) option for trust modification or termination (or one similar to it) could be used by a state Medicaid program to create difficulties. Because the UTC § 411(a) option allows modification or termination if the settlor and all beneficiaries agree, my concern is that in the self-settled trust context the statute poses a "circumstance" under which the trust could, in fact, be distributed to the settlor.

I know of no case or dispute in which this issue has arisen, and perhaps I am worrying needlessly. In any event, UTC § 105 provides that the provisions of the Act, other than an explicit set of exceptions, are generally default provisions that may be overridden by the terms of the trust agreement. The early termination provisions of UTC § 411(a) are not on the list of mandatory provisions that may not be overridden by contrary trust agreement language. Accordingly, to avoid my concerns (or, for that matter, concerns expressed by the court in *Doherty* that the trust could be terminated and a portion of the assets

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[32] 42 U.S.C. § 1382b(e)(3)(B) applies the same rule in the SSI context.

distributed to Mrs. Doherty) it may be worth considering whether to add a provision with respect to terminating distributions.[33]

B. Revocable Trust Powers Exercisable by an Agent

UTC § 602(e) provides that an agent under a power of attorney may revoke or amend a revocable trust or elect to distribute trust property only if expressly authorized to do so. A conservator may do so upon court approval pursuant to UTC § 602(f). This could, in my opinion, lead to some mischief.

As mentioned above, North Carolina goes further and its version of UTC § 602(e) (currently codified at NCGS § 36C-6-602.1) authorizes an agent to revoke a revocable trust on the principal's behalf as long as the revocation does not "alter the designation of beneficiaries to receive property on the settlor's death under the settlor's existing estate plan."

VIII. Conclusion

Many attorneys draft trusts (particularly through document assembly systems[34]) without a good grasp of their states' basic trust laws. These laws are not particularly difficult. But gaining an understanding of them will take an investment of some time and effort.

My hope is that this outline will offer a good starting point. Every attorney preparing trusts should have a basic understanding of his or her state's laws pertaining to the creation of a valid trust, as well as the availability of legal tools such as the ability to terminate, modify, decant or change the situs of a trust. I also hope that this Outline has made the important point that some state law "default" settings and thoughtlessly added (or omitted) trust provisions can cause Medicaid and SSI issues.

A curse on boilerplate!

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[33] Perhaps something like, "In the event this Trust is terminated for any reason whatsoever, trust assets shall be distributed to those beneficiaries who would be entitled to a distribution from the trust upon the death of the Settlor."

[34] Many of which are excellent systems.