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New Rules for Modification or Termination of Trusts

With the increase in the estate tax exemption to \$11.2 million per person (see related article on tax reform), you should consider whether an existing irrevocable trust originally put in place for estate tax avoidance purposes still makes sense. Because the irrevocable trust assets likely will not receive a basis adjustment for income tax purposes upon the termination of the trust, it is possible that, under the new law, the irrevocable trust may actually increase taxes (i.e., capital gains taxes) rather than serve to reduce taxes (i.e., estate taxes).

Under new California law effective in 2018, the procedures for modifying or terminating an irrevocable trust have been relaxed to some degree. Before 2018, the court had limited authority to modify or terminate an irrevocable trust which contained a spendthrift clause (see related article on a creditor's access to a beneficiary's trust), even when all of the trust beneficiaries consented. Now, with the consent of all of the trust beneficiaries, if the court finds good cause to do so, it may approve a modification or termination of an irrevocable trust, regardless of a spendthrift clause, so long as the court determines that the reason for modifying or terminating the irrevocable trust outweighs the interest in accomplishing the material purpose of the trust. The new law also authorizes the court to limit the class of beneficiaries whose consent is necessary to modify or terminate the trust.

Also, if the person who established the irrevocable trust (i.e., the settlor) is still living, the new law clarifies that the modification or termination of the trust may be done without court approval as long as the settlor and all beneficiaries agree in writing.

Under continuing law, the court retains its authority to terminate an irrevocable trust with uneconomically low principal, and the court may modify or terminate an irrevocable trust if there are unanticipated changed circumstances that would defeat or substantially impair the accomplishment of the purposes of the trust.

If you are the settlor, trustee or beneficiary of an irrevocable trust that you believe may no longer be serving its original purpose, please contact us to discuss the potential modification or termination of the trust. Please note that it is always important to consider the income and other tax consequences, and any non-tax objectives, before an irrevocable trust is modified or terminated.