Trust Mergers

Take-Away: In limited situations, a merger of two trusts might be more effective than a decanting of one trust to another trust, or a trust modification under the Michigan Trust Code which involves the probate court's approval.

Background: In certain situations, a trustee might consider merging two trusts into a single trust. Such a merger could simplify trust administration, reduce expenses, 'fix' drafting mistakes, or address a change in circumstances like tax laws, much like a trust modification can accomplish. Avoiding having to pay for a separate trust income tax return or merging trust portfolios to qualify for lower asset management fees are just a couple of the practical reasons why two trusts might be merged by the trustee into a single trust. As such, a trust merger might be viewed as an alternative to a trust decanting decision or a more formal trust modification proceeding under the Michigan Trust Code. However, the ability to merge two trusts into a single trust has some constraints that must be addressed. It is always to remember that a merger prompted by administrative convenience should never override a beneficiary's rights.

Trust Mergers: The ***Restatement (Third) of Trusts, Section 68*** authorizes a trustee to combine two trusts into a single trust if doing so does not adversely affect the rights of any beneficiary or the accomplishment of the trust's material purpose. [As an aside, the earlier *Restatement (Second) of Trusts* did not recognize this fiduciary authority.] The *Restatement's* authorization that gives a trustee the right to merge trusts is reflected in the Uniform Trust Code, and correspondingly in the Michigan Trust Code.

Michigan Trust Code: The Michigan Trust Code expressly gives the trustee the authority to either divide a trust or consolidate trusts. The trustee's authority to merge trusts is found at MCL 700.7417(2), which provides:

(2) After notice to the qualified trust beneficiaries and to the holders of powers of appointment, a trustee may consolidate 2 or more trusts and administer them as 1 trust if the trusts have substantially identical terms and conditions or if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust. If the rule against perpetuities speaks from different dates with reference to the trusts or if there

are other variations in terms, consolidation may still take place, but the property of the trusts shall be maintained in separate accounts if necessary to recognize and give effect to the differences.

Substantial Identical Terms: The official comments to the UTC version [Section 417] on which Michigan's authority is based, notes that the two trusts do not have to have identical terms but that comment notes "the more the dispositive provisions of the trusts to be combined differ from each other the more likely it is that a combination would impair some beneficiary's interests." As a general rule-of-thumb, trust mergers are appropriate only when the two trusts share identical or very similar beneficiaries and dispositive terms.

Only Notice: What is important to note is that unlike most trust modification provisions of the Michigan Trust Code, Michigan's trust merger provision does not require the approval of the probate court, nor does it require the consent of the trust beneficiaries, just advance notice (of some amount of time) to the trust beneficiaries similar to the advance notice requirement for a trust decanting.[MCL 700.7820a(7), which has a 63 day advance notice requirement.] Would a week's written notice be sufficient under the MTC?

Fiduciary Duties: Since the trustee has the duties of loyalty and impartiality to its beneficiaries, it must be careful before it exercises its power to merge two trusts. If the beneficiaries of the two trusts are somewhat different, a trust merger could compromise a beneficiary's expectation of privacy and control, e.g., a trust for Ken should not be merged with a trust for Barbie, where information that Ken is entitled to receive would also be available to Barbie.

Income Taxes: The merger of two trusts can have significant income tax consequences. If two *grantor* trusts are merged, there should be no problem since transactions between two *grantor* trusts are considered non-events for federal income tax purposes. [Revenue Ruling 85-13.] However, a merger of a *grantor* trust with a nongrantor trust, with different settlors, can trigger adverse tax consequences, since under state law the two trusts would not be treated as 'similar.'

Capital Gains: While the Tax Code provides that asset transfers between taxpayers can trigger a gain, with a trust merger, done by the trustee pursuant to statutory authority and without the exchange of consideration, then IRC 1001 should not apply, which should make the merger of the trusts a non-recognition event. Correspondingly, if IRC 1001 does not apply, then the basis of trust assets from the 'merged' trust to the 'surviving' trust will be the same. [IRC 1015], and the holding periods of the assets held in the 'surviving' trust will be the same. [IRC 1223(2); Private Letter Ruling 200743022.]

DNI: The IRS has also noted in several private letter rulings that when two trusts are merged, the transfer of assets (from the 'merged' trust to the 'surviving' trust) is not treated as a distribution that carries out distributable net income (DNI) to anyone, nor will it be a realization event by the 'surviving' trust or the beneficiaries of any income, gain or loss. [Private Letter Ruling 200607015.]

Gift Taxes: While seemingly the merger of identical trusts should not create any gift tax exposure, if the merger even slightly alters beneficial interests, or consents are obtained improperly, the risk of a *deemed gift* surfaces.

Example: Under the 'merged' trust, Rose possessed the vested right to an outright distribution of trust assets at the age of 35 years. In the 'surviving' trust Rose's right to an outright distribution is now 45 years. Rose may be viewed by the IRS as agreeing to give up her right in favor of the 'surviving' trust, if Rose were to die between the ages of 35 and 45, which implies that Rose made a gift (of some value) to the remainder beneficiaries of the 'surviving' trust. So far that IRS has not be helpful in describe how this *deemed gift* should be valued.

Deemed Gifts: You will recall from prior missives that reported on Chief Counsel Memorandum (CCM) 202352018, that the IRS is on the lookout for deemed gifts by trust beneficiaries. In that CCM the IRS concluded that when a trustee seeks a judicial modification of a trust that alters beneficial interests, and pursuant to state statute, the beneficiaries of the trust consent to that trust modification, a taxable gift occurs.

Moreover, the IRS also concluded in that same CCM that the deemed gift would be the same if the trust modification was pursuant to a state statute that provides the trust beneficiaries with notice and a presumed right to object to the trust modification and the beneficiary fails to exercise his/her right. This CCM appears to be an extension of a prior revenue ruling in which a beneficiary's failure to object to a final probate account resulted in a taxable gift by the beneficiary. [Private Letter Ruling 84-105.]

A taxable gift should not be a problem if the merger of the two trusts does not diminish any beneficiary's interest. If the beneficiary finds himself/herself in the same economic position after the trust merger, there should be no deemed gift problem.

Example: Elliott is a beneficiary of a trust his grandfather created for him. Elliott holds a limited power of appointment over that trust to appoint assets to the descendants of his grandparents, excluding Elliott. The grandparents' trust is merged into another trust that was created by Elliott's parents. The parents' trust does not give Elliott any power of appointment. The grandparents' trust is merged into the parents' trust. Elliott may be treated as having made a deemed gift, since this change could be viewed as shifting some 'value' (the ability to control) to the remainder beneficiaries of the 'surviving' trust. How to value the released ability to control via the abandoned limited power of appointment, is anyone's guess.

Estate Taxes: If the trust merger changes powers or trust terms in a way that causes inclusion of trust assets in the beneficiary's estate, when it previously would not have presented that problem, estate taxes might be triggered.

Example: Elaine, the trust beneficiary, hold a testamentary limited power of appointment in the 'merged' trust her grandparents created for her. Elaine's parents created their own irrevocable trust for Elaine over which she now holds a testamentary general power of appointment to appoint assets to the creditors of Elaine's estate. The grandparents' trust is merged into the parents' trust, which is the 'surviving' trust. With this subtle change, the entire value of the combined two trusts will be included in Elaine's gross estate on her death (with an income tax basis adjustment at that time to 'both' trusts' assets.)

Generation Skipping Transfer Taxes: This tax, and its inclusion ratios, is probably where a trustee needs to proceed with extreme caution when considering the merger of two trusts. The issue is when one trust is truly exempt from the GSTT, either because it is 'grandfathered', i.e., created prior to 1985, or it is exempt because of the use of the settlor's GSTT exemption to that transfer that funded the trust making it GSTT exempt, yet the other trust is not GSTT exempt, and thus it has an inclusion ratio. With the merger of the trusts with different inclusion ratios, the 'surviving' trust will have blended inclusion ratio of greater than zero. Thus, it is probably best to not merge a GST exempt trust with a non-exempt trust or be prepared after the merger to engage in a qualified severance of the 'surviving' trust into segregated shares. [Regulation 26.2642-6.]

Conclusion: A trust merger is just one more option that a trustee might explore when there is a good reason to bring trust assets under a different trust. No probate court approval is apparently required for the trust merger, and while consent is required to be given to the trust beneficiaries, unlike the trust decanting statute, no specific period of advance notice of intent is set forth in the merger statute, which might imply that no period is contemplated where the trust beneficiaries can file objections. Whether this distinction is sufficient, notice only, to avoid a deemed gift by the beneficiary who receives notice but does not formally consent, is anyone's guess when it comes to the IRS. Thus, while a trust merger is a power that the trustee possesses, it is definitely a power that should be exercised only with extreme caution and only after an analysis that the terms of both trusts, along with the beneficiaries of both trusts, are *substantially identical*.

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