Merge with Caution: The Ins and Outs of the Merger of Trusts

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INTRODUCTION

It is not uncommon for an estate planner or tax advisor to receive the following complaint from a client: “I’ve got all these trusts that were created by my parents 40 years ago, as well as several others that were created on their deaths. Isn’t there something we can do to get rid of some of them?” In other situations, the planner may be asked: “Can you fix it?” when discussing with his or her client a trust document that was not drafted properly or contains antiquated tax or administrative provisions. In both these scenarios, as with most client requests, the answer should be “Possibly.” Trust merger can be an extremely effective tool in the estate planner’s toolbox when faced with the preceding questions. In fact, merging trusts may be quite useful for many reasons.

In the 1970s, it was not uncommon to create multiple trusts for a client and his or her family, taking advantage of the favorable income tax brackets for trusts. As that disparity in income tax rates disappeared with the reduction in income tax rates for individuals, it has become quite inconvenient for clients to maintain multiple trusts.

Probably more important to the client than the inconvenience of keeping track of multiple trusts is the cost associated with maintaining the trusts. Whether it be investment fees, trustees’ fees, or professional fees, these costs may be reduced significantly if the number of trusts involved is reduced. If the number of trusts is reduced, so will the number of tax returns that must be filed, further reducing costs. In fact, a trustee may have a duty or responsibility to pursue a combination of trusts in certain cases — to take advantage of cost efficiencies. The comment to Uniform Trust Code (UTC) §417 (the section governing the merger of trusts in states that have adopted the UTC) discusses the administrative economies that may be achieved through merger. UTC §805 provides that, “[i]n administering a trust, the trustee may incur only costs that are reasonable in relation to the trust property, the purposes of the trust, and the skills of the trustee.” The comment to UTC §805 provides that the “duty not to incur unreasonable costs applies when a trustee decides whether and how to delegate to agents, as well to other aspects of trust administration.”

The investment opportunities that are available to the trustee may be limited by the size of the trust assets invested. The trustee may be able to access more investment options if trusts are merged, thereby creating a larger pool of capital to be invested.

Finally, merging irrevocable trusts can be extremely useful to address issues arising when circumstances have unexpectedly changed over time, or if there are specific problems in a trust document itself. If a trust agreement contains problematic provisions, other than those relating to the beneficiary’s specific interests, it may be possible to merge the problem trust into another trust, whether an existing trust or a newly created one. Merger can also actually be a cost effective alternative to judicial proceedings aimed at correcting the trust defect.

Much has been written over the last several years about decanting as an effective technique to address issues arising when circumstances have changed or when issues are discovered with a trust document itself. Decanting is the distribution of trust property by the trustee to a different trust (usually a newly created trust) pursuant to the trustee’s power to make discretionary distributions for the benefit of the beneficiary. While the power to decant does give the trustee considerable flexibility, its availability is limited. A trust document itself may specifically provide the trustee with the power to decant, but such provisions are rare. In addition, only 10 states have currently enacted decanting statutes: Alaska, Ari-
ora, Delaware, Florida, Nevada, New Hampshire, New York, North Carolina, South Dakota, and Tennessee. On the other hand, most state statutes and trust instruments specifically authorize the merger of trusts. Therefore, the trustee’s only option to address any of the situations described above may be merger.

As with any estate planning tool or technique, trust merger is not available, and should not be used, in every situation. In addition, there are specific requirements, whether set forth in the trust documents or in the applicable state statutes, that must be met before trusts can be combined. The beneficiary’s interests must also be considered very closely. And, as with most estate planning and trust administration, tax implications and consequences must be considered.

AUTHORITY TO MERGE

Trust Provisions

When considering combining trusts, the obvious starting point for the practitioner is the applicable trust documents. Oftentimes a trust agreement will contain a provision that specifically authorizes the trustee to consolidate or merge trusts. An interesting question arises when the merger powers in the subject trust documents differ. For example, one trust document may allow the trustee to merge two or more trusts as long as the trusts have substantially similar terms and the beneficiaries of each are identical. The other trust, however, might only allow the trustee to merge two or more trusts if the trust terms, as well as the beneficiaries, are identical. The more restrictive trust provisions would presumably restrict the merger in that case.

But, must all trust terms be identical in that situation, or only the dispositive provisions? If the trust documents require the trust terms and the beneficiaries to be identical, it seems that trust merger opportunities would be extremely limited, if for no other reason than it would be rare to find two identical trusts in place for identical beneficiaries.

When drafting trusts, the practitioner should consider revising the trust merger powers to allow the trustee to merge trusts that have similar, or at most substantially similar, terms — thereby providing the trustee with flexibility to deal with changing circumstances in the future. A trust protector named in a trust — who is authorized in that document to modify the administrative provisions of a trust to address unanticipated situations in the future — may also be able to modify the trust merger power to allow consolidation of trusts in a situation where the document would not otherwise allow it.

State Law

What if one or both of the trust instruments are silent with respect to the trustee’s ability to consolidate or merge trusts? The practitioner must then look to applicable state law. Most state trust statutes specifically authorize the combination of multiple trusts.

UTC §105 provides that, in most cases, the “terms of the trust prevail over any provision on the” UTC. Therefore, if a trust is silent with respect to consolidation, the specific provisions of the UTC will apply. The UTC actually provides a somewhat detailed, and logical, approach to the merger of trusts. Specifically, UTC §417 states that, “[a]fter notice to the qualified beneficiaries, a trustee may combine two or more trusts into a single trust . . . , if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.” The comment to UTC §417 provides that “[t]his Section is subject to contrary provision in the terms of the trust.” Further, it “allows a trustee to combine two or more trusts even though their terms are not identical . . . [however, 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 interest, hence the less likely that the combination can be approved.” The comment further states that UTC §417 “does not require that a combination . . . be approved either by the court or by the beneficiaries. Prudence may dictate, however, that court approval under Section 410 be sought and beneficiary consent be obtained whenever the terms of the trusts to be combined . . . differ substantially from one another.”

Of the 27 states that have not adopted (or are in the process of adopting) the UTC, most specifically authorize trustees to consolidate two or more trusts, although those statutory provisions vary significantly. Most, however, are not as thorough as UTC §417 in their guidance on the topic. For example, §4.25 of the Illinois Trusts and Trustees Act (760 ILCS 5/4.25) states that the trustee of a trust has the power to “consolidate 2 or more trusts having substantially similar terms into a single trust.”

Care must be taken when reviewing the trust documents and applicable state statutes, as a trust merger that results in the impairment of a beneficiary’s rights could result in harsh consequences for the trustee. With this in mind, most trust provisions and state statutes provide enough flexibility in the consolidation of trusts to allow combination of trusts to achieve the desired results described at the outset of this article.

1 Effective July 1, 2011, West Virginia became the 23rd state to adopt the UTC, joining Alabama, Arizona, Arkansas, Florida, Kansas, Maine, Michigan, Missouri, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, and Wyoming, as well as the District of Columbia. Other states have introduced or may be reviewing bills to adopt the UTC.
**TAX CONSIDERATIONS**

Assuming that trusts can be merged, as a result of either the trust provisions themselves or applicable state law, the tax implications should be considered before the trusts are consolidated. A merger of trusts will inherently result in the termination of one of the trusts. Therefore, the practitioner must review the income, gift, estate, and generation-skipping transfer (GST) tax aspects of the subject trusts. Each of these taxes has its own set of intricacies that must be examined.

**Income Tax Considerations**

There are actually several layers of income tax considerations that must be analyzed. What is the status of each trust for purposes of the grantor trust rules pursuant to §§671–679? Will gain or loss be realized on the merger? What if the property held in the trust being merged out of existence is encumbered? What becomes of the distributable net income (DNI) of the trust being merged out of existence?

The income tax status of each of the trusts (grantor trust, simple trust, or complex trust) should be assessed before any merger is effectuated. Merging one grantor trust into another grantor trust (both with the same grantor for income tax purposes) should not give rise to any income tax issues. Regs. §1.671-2(e)(5) provides that, if a trust makes a gratuitous transfer of assets to another trust, the grantor of the transferring trust will be treated as the grantor of the transferee trust. In addition, transactions between grantor trusts having the same grantor are generally disregarded for income tax purposes.

However, the fact that one of the trusts is a grantor trust while the other is not (or that both trusts are grantor trusts but as to different grantors) may be enough to prevent the trustees from consolidating the trusts — i.e., the trust provisions would not be identical or substantially similar enough to meet the document/state law requirement for merger.

But what if the grantor trust status of the trust is determined solely by the identity of the trustee, with the beneficiaries and trust terms otherwise aligned in such a way as to satisfy the document/state law requirements? The trustees must consider not only the income tax implications to the grantor of each trust, the trusts themselves, and the beneficiaries, but also the grantors’ intent as well as each of the trustee’s fiduciary duties to the trust beneficiaries.

Generally, the merger of one trust into another should not trigger the recognition of gain or loss. Although one trust naturally terminates on the consolidation, for income tax purposes, the determination of whether a trust has terminated depends on whether the trust property has been distributed to the applicable beneficiaries.

In addition, the merger of trusts should not result in the sale or exchange of trust property under §1001, because the merged trust ceases to exist after the merger — it is not receiving any property in exchange, let alone any property that is materially different from the property being conveyed to the surviving trust.

In PLR 200743022, the Service was asked to rule on whether the merger of several trusts into newly created trusts would cause the original trusts, the new trusts, or the beneficiaries themselves to recognize gain or loss under §661 or §1001. The Service concluded that:

In this case, State Statute clearly authorizes the consolidation or merger of trusts by the trustees where the merger or consolidation is in the best interests of the beneficiaries. Moreover, the terms of the trust instruments establishing the original trusts authorize the trustees to execute the necessary documents in order to carry out the powers granted the trustees with respect to the transfer of assets from the trusts. By virtue of the trust powers granted to the trustees under the State Statute and the original trust instruments, the trustees of the original trusts are authorized to merge the assets into the new trusts and to transfer trust assets from the original trusts to the new trusts. Consequently, the beneficiaries of the new trusts are acquiring their interests in the new trusts by reason of the exercise of the trustees’ existing authority under state law to merge or consolidate the original trusts and to transfer the trust assets in furtherance of this merger. The beneficiaries are not therefore acquiring their interests in the new trusts as a result of the exchange of their interests in the original trusts, or as the result of an exchange of interests between themselves. Accordingly, there does not appear to be any reciprocal exchange involving the legal rights and entitlements of the beneficiaries under the trusts here. Because no “exchange” has occurred

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2 A “grantor trust” is a trust of which the settlor is treated as the owner pursuant to §§672–679 and, therefore, includes in his or her personal tax computation all items of income, deductions, and credits attributable to the trust (or portion thereof) of which he or she is deemed the owner.


4 See Regs. §1.641(b)-3(b).

5 See Regs. §1.1001-1(a).
for purposes of §1001, it is unnecessary to analyze whether the “materially different” standard has been satisfied.

We therefore conclude that the proposed mergers of the original trusts into the new trusts, and the transfer of assets from the original trusts to the new trusts, will not cause the original trusts, the new trusts, or any of the income beneficiaries to recognize any gain or loss under §1001 from a sale or other disposition of property.

In that same ruling, the Service also considered whether the assets transferred to the new trusts would have the same basis and holding period as they had in the original trusts. The Service again ruled positively, stating that:6

Because §1001 does not apply . . ., under §1015 the basis of the trust assets will be the same after the proposed transaction as the basis of those assets in the original trusts. Furthermore, pursuant to §1223(2) the holding periods of the assets in the hands of the new trusts will include the holding periods of the assets in the hands of the original trusts.

What if the property held by the trust being merged out of existence is encumbered, or what if that property consists of an LLC or partnership interest with a negative capital account? The Supreme Court, in Crane v. Comr.,7 held that when property subject to nonrecourse liability is sold, the seller realizes gain, not only with respect to the cash or other property received as a result of the sale, but also with respect to the amount of the liability. In addition, Regs. §1.1001-2(a) provides that “the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.” [Emphasis added.]

The transferor of a partnership or LLC interest with a nonrecourse liability is sold, the seller realizes gain, but the practitioner must still consider the implications. In most instances, there should be no gift or estate tax consequences of a merger of two or more trusts, but the practitioner must still consider the implications. For example, if state law or the trust document requires that a beneficiary consent to the merger of the trusts or if the consenting beneficiary’s interests are being diluted in any way as a result of the merger, the beneficiary may be deemed to have made a gift.10

Taking that argument one step further, the beneficiary’s silence, or lack of contest, could be considered

10 See 852 T.M., Income Taxation of Trusts and Estates.

6 The IRS has issued many similar rulings. See, e.g., PLRs 200552009, 200544007, 9619047.
7 331 U.S. 1 (1947).
8 Regs. §1.1001-2(a)(4)(v); see also §752(d).
9 §643(e).

Federal Gift and Estate Tax Consequences

In most instances, there should be no gift or estate tax consequences of a merger of two or more trusts, but the practitioner must still consider the implications. For example, if state law or the trust document requires that a beneficiary consent to the merger of the trusts or if the consenting beneficiary’s interests are being diluted in any way as a result of the merger, the beneficiary may be deemed to have made a gift.11

Taking that argument one step further, the beneficiary’s silence, or lack of contest, could be considered
acquiescence resulting in a gratuitous transfer. However, because the states that have adopted the UTC provide that trusts can be merged only if the beneficiaries’ rights will not be impaired, and most other state merger statutes or the applicable trust provisions require the substance of the dispositive trust terms to be, at a minimum, substantially similar, if not actually identical, the beneficiary’s interests will likely be the same before the merger and after. As a result, assuming that the dispositive provisions, including powers of appointment, of the surviving trust are consistent with the same provisions of the trust being merged out of existence, no taxable gift should result from the merger. 12 This would not be the case if the beneficial interest was being shifted to a different beneficiary, but if that were the case, merger probably would not be authorized (either by statute or the trust document). Regs. §25.2511-1(g) provides that the transfer of bare legal title to a trustee would not constitute a taxable gift, but a transfer of the beneficial interest in property would.

Assuming the grantor of the trusts has no involvement in the merger of the trusts, the merger itself should not cause inclusion of the trust assets in the grantor’s taxable estate pursuant to §2036 or §2038. If, however, the grantor has a §2036 or §2038 power over one or both of the trusts that survives the merger, the trust assets will be includible in the grantor’s taxable estate.

**Generation-Skipping Transfer Tax Consequences**

Potentially the biggest concern from a tax perspective that the practitioner must consider is the status of the trusts for GST tax purposes. There are several GST tax traps for the unwary that can have devastating tax effects if not contemplated before a trust merger is completed.

**Grandfathered Trusts**

The unwitting merger of a trust that is grandfathered for GST tax purposes into a trust with no such status could be disastrous.

Regs. §26.2601-1(b) defines a GST tax-exempt trust as a trust that was irrevocable on September 25, 1985 or a will or revocable trust executed before October 22, 1986, if the decedent died before January 1, 1987. Pursuant to Regs. §26.2601-1(b)(1), an addition to such a “grandfathered” trust will cause it to lose its GST tax-exempt status. Such an addition may be an actual addition or a constructive or deemed addition. Therefore, extreme care must be taken when merging a grandfathered trust so that no actual or constructive addition is made.

Regs. §26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under Regs. §26.2601-1(b)(1), (2), or (3) will not cause the trust to lose its exempt status. The rules contained in Regs. §26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. Example 6 of Regs. §26.2601-1(b)(4)(i)(E) specifically addresses the GST tax treatment of the merger of grandfathered trusts:

In 1980, Grantor established an irrevocable trust for Grantor’s child and the child’s issue. In 1983, Grantor’s spouse also established a separate irrevocable trust for the benefit of the same child and issue. The terms of the spouse’s trust and Grantor’s trust are identical. In 2002, the appropriate local court approved the merger of the two trusts into one trust to save administrative costs and enhance the management of the investments. The merger of the two trusts does not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the merger. In addition, the merger does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Therefore, the trust that resulted from the merger will not be subject to the provisions of chapter 13 of the Internal Revenue Code.

The example provides the roadmap for the merger of trusts that are grandfathered trusts for GST tax purposes to avoid the merger being considered a constructive addition. First, no beneficial interest should be shifted to a beneficiary at least one generation below a beneficiary of a trust being merged. Second, the time for vesting of a beneficial interest should not be extended beyond the time set out in the original trust documents.

The Service has been asked to privately rule on mergers involving grandfathered trusts on many occasions. For example, see PLRs 9610021, 9619047, and 201025026, all of which concluded that the merger of the subject grandfathered trusts did not result in additions to the merged trust, and the merger did not af-

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12 See, e.g., PLR 9619047.
fect the grandfathered status or cause any distributions to be made from the merged trust to become subject to GST tax. There have also been many Private Letter Rulings concluding that the merger of a grandfathered trust into a newly created trust (with the same terms) did not affect the GST tax-exempt status — the merger did not constitute a constructive addition and did not cause a distribution from, or termination of any interest in, any of the trusts to be subject to the GST tax.13

**Inclusion Ratio**

Regs. §26.2642-4(a)(2) provides that, for purposes of determining the inclusion ratio of the resulting trust for GST tax purposes, “[i]f two or more trusts created by the same transferor are merged or consolidated, it is necessary to determine a single applicable fraction for the merged trust. The numerator of the new fraction is determined by adding the nontax portions of each trust immediately before the merger.”14 An example in 850 T.M., *Generation-Skipping Transfer Tax*, illustrates the calculation of the inclusion ratio in the case of trust merger:

**Example:** In 2000, T creates Trust A with a transfer of $800,000 and allocates $600,000 of GST exemption to it. This results in an applicable fraction of .750 and an inclusion ratio of .250. In 2004, T dies and his will creates Trust B with a transfer of $800,000 and T’s executor allocates $160,000 of GST exemption to it. This results in an applicable fraction of .200 and an inclusion ratio of .800. The trust terms are identical and the trustees of the two trusts merge the trusts when the value of Trust A is $1,000,000 and the value of Trust B is $1,000,000. The nontax portion of Trust A is $750,000 (.750 × $1,000,000). The nontax portion of Trust B is $200,000 (.200 × $1,000,000). The numerator of the applicable fraction of the merged trust is the sum of the nontax portions of each trust, which is $750,000 + $200,000, or $950,000. The denominator of the fraction is the value of the merged trust, or $2,000,000. The applicable fraction is $950,000/$2,000,000, or .475, and the inclusion ratio is .525.

**MERGER MECHANICS**

Assuming that the proposed merger of two or more trusts will meet the requirements imposed by the trust documents or applicable state law, and assuming that a satisfactory conclusion has been reached regarding the tax ramifications of the merger (whether the analysis is just completed by counsel and/or accountants, or whether a private letter ruling is obtained if the situation warrants), the trusts can then actually be merged.

If court approval is required, the appropriate petition must be filed and court procedures followed. If no court action is required, a merger document should be prepared and signed by all of the necessary parties. The assets of the trust being merged out of existence must be transferred to the surviving trust. The necessary assignments and other title documentation must be completed by the trustees.

A final federal income tax return should then be filed for the trust that is being merged out of existence. That final income tax return will include a Schedule K-1 containing all items of income, deduction, gain, loss, and carry-forwards and showing the surviving trust as the beneficiary. All such items are then picked up on the surviving trust’s income tax return.

**CONCLUSION**

As with any estate planning technique, the consolidation of two or more trusts can be a very effective method of achieving the goals of the client, but the state law and tax aspects must be examined closely. The ultimate consideration that the trustees, and the practitioner, must keep at the forefront of the analysis, as described in the comment to UTC §417, is that the combination of trusts should not impair a beneficiary’s interest. If the merger can be accomplished without impairing the beneficiary’s interests, and with no adverse tax consequences, the consolidation of trusts can be a relatively straightforward way of reducing the number of trusts in place for a beneficiary (and the corresponding administrative costs), taking advantage of economies of scale in the investment of trust assets, or fixing a trust or trusts with problematic trust provisions.

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13 See, e.g., PLR 200743022, 200743019.
14 See, e.g., PLRs 200715002, 200403072, 200234043, 9728030.