IN TRUSTS WE SHOULD TRUST – TRUST PLANNING

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I. INTRODUCTION

As America's greatest generation -- the baby boomers -- age gracefully, they are also accumulating wealth as no other American generation before (stock market adjustments notwithstanding). Even with recent income tax rate cuts and an estate tax phase out, trusts can play an important role in asset protection strategies. Yet, like many amazing and inexplicable things surrounding us in daily life -- television, penicillin, Coach R. C. Slocum -- we take trusts for granted without really knowing how they work. Charitable remainder trusts, QTIP trusts and Crummey Trusts are examples of different trusts. This paper presents an overview of the different types of trusts and how they may be used for asset protection and in estate planning. The paper provides a brief history of trusts, and some insight into related expenses. It is written to provide a reference guide to trusts useful for holding one's own at cocktail party discussions with other lawyers without having to defer to some "board certified" expert. In sum, a reader who regularly ignores trusts should come away with an enhanced appreciation of trusts and their uses.

II. THE BASICS

A trust arrangement involves a transfer of property to someone (the Trustee) on his/her promise to hold the trust property (the corpus) according to the transferor's (Settlor/Trustor) instructions.[1] These trust basics remain the same today, despite the great complications discussed herein, as they were in Roman Empire days where the modern trust form has its roots.[2] Whether a trust is created while one is among the living (inter vivos) or comes into existence upon death (testamentary), there seem to be common goals of preservation and protection of assets from taxes and other creditors for present and future beneficiaries, provision for basic needs of beneficiaries, professional and fiduciary management of assets, and peace of mind.

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[1] CORNELIUS J. MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY, 176-180 (1962).
[2] DANIEL, SITAZZ, LAW OF THE U.S. – WILLS AND TRUSTS 136-38 (1999).

Lawyers, accountants, bankers and other financial professionals are familiar with the basic trust functions and terminology. The full uses of a trust and major pitfalls of trust misuse are not as familiar. Who or what should be the Trustee, fatal terms, proper distributions, accounting and estate planning are salient issues to explore.

III. THE TRUSTEE

If a person wants to "man his own canon," he or she can name himself or herself as trustee and could be the beneficiary as well, so long as the trust provides for some other beneficiary after the beneficiary's death (commonly known as a "gift over"). Naming oneself as trustee provides full control and, if death or disability ensues, naming an independent or disinterested successor trustee allows the trust to continue without negative tax consequences. A spouse is not a bad selection as trustee provided an ascertainable standard is put in place to guide the trustee as to discretionary distribution of trust principal and income, for example, "Heath, Education, Maintenance, and Support."[3] If one gets creative or outside the box of the four standard words, such as providing for comfort, the entire trust (a bypass as discussed later) could be thrown into the spouse's estate for tax purposes.

Naming a friend as trustee is problematic if the friend is not qualified or competent. Choosing an institution, such as a bank or trust company, has become more popular because of the experience and competence factors as well as the financial responsibility and continuity factors. Corporate trustees have regulated fees usually disclosed up front; However, corporate trustees can also have "sticky fingers" and can be cold and unresponsive. Attorneys can tell many tales of having to sue or threaten litigation against a large bank trustee for not releasing funds to pay for a beneficiary's emergency appendectomy or properly documented tuition. One suggestion to mediate the coldness of a corporate trustee is to add one's spouse or family member as a co-trustee. Another option would be to give one's spouse the power to remove the cold corporate trustee and appoint a friendlier corporate trustee, and presumably one whose performance is better.[4] Some smaller trusts (up to $400,000) may choose to use a family member or attorney for economy.

IV. TRUST TERMS

A trustor should go beyond the simple trust bank account and establish some clear guidelines for trustee actions involving:

(1) distributions (lifetime) of assets and income;
(2) conditions for distributions;
(3) death of beneficiaries during the trust;
(4) successor trustee(s) and powers
(5) asset protection from creditors (a "spendthrift" clause); and

[3] ALEXANDER A. BOVE, WILLS,ESTATES AND TRUSTS 2ND ED. (2000).
[4] *Id.* at 171-72.

(6) usual and customary trust provisions as well as boilerplate clauses commonly understood under court cases and state statutes, such as, regular accounting of trust income, expenses and distributions.[5]

The "spray" or "sprinkle" clause should allow the trustee to distribute income (or principal) to beneficiaries as and when the trustee deems appropriate without having to make equal payments. The trustee may decide not to make such distributions over a period of time according to the changing needs of beneficiaries. Most authors (and parents) agree that the trustee should make the ultimate distribution when the beneficiary has attained a responsible age (whatever that is).

Rather than require a release by the trustee of a lump sum to an 18 or 21 year old, estate planners should allow the trustee to spread installment distributions over a period of years slowly inoculating the beneficiary as to mature and careful handling of wealth. A 25 to 30 percent distribution at age 25 and likewise each five years thereafter seems prudent for all concerned. (Of course, prudence is not synonymous with fun.) Trustees should always have the flexibility to meet the needs of beneficiaries who are accepted at Vanderbilt, get married, have children or fall ill.[6]

V. TYPES OF TRUSTS

One important use of a trust is to avoid estate taxes so long as such are assessed on graduated estates sizes through the year 2009 exceeding $3.5 million. Estate taxes are to be phased out after 2000, yet one has to wonder whether Congress can give up this "politically correct" source of revenue in the future. Given the present and near future of the estate tax structure, the trusts recommended for estate planning consist of: (1) Marital Deduction Trust or AB "Family" Trust, (2) QTIP Trust, (3) Crummey Trust, amd (4) Retained Interest Trust such as GRITS, GRATs, GRUTs, and QPRTs.

A. FAMILY TRUSTS

With a family trust, each spouse establishes a revocable living trust with a provision that upon death, the deceased spouse's estate is divided into two irrevocable trusts: (1) a Marital Deduction Trust for the benefit of the surviving spouse, and (2) a Bypass/Family Trust for the benefit of surviving spouse and children.

If a spouse leaves his or her entire estate outright tot the surviving spouse, no estate taxes are assessed.

B. QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUSTS

If, however, the surviving spouse ends up with a taxable estate upon his or her death, the tax consequences could be brutal. If the deceased spouse's estate is left in trust for the surviving spouse, certain requirements must be met: (1) The surviving spouse must be the only beneficiary during his or her lifetime and (2) he or she must either have unrestricted power to dispose of the trust assets on her death, or the surviving spouse

[5] *Id.* at 174.
[6] FIDELITY INVESTMENTS, OVERVIEW OF THE TRUST BUSINESS 19 § 5 (2001).

must receive all trust income at least annually during his or her lifetime allowing the settlor (who created the trust) to direct the disposition of the trust assets on the surviving spouse's death such as to children of a prior marriage. This last power is called a qualified terminable interest property trust or QTIP where the settlor wishes to take care of the surviving spouse but to be certain his or her children receive the trust assets.[7]

Example: H has assets of $2.5 million and W has $300,000. If H dies in 2003, $1,500,000 can pass exempt to anyone, but the entire 2.5 million may pass to wife tax-free, making wife's estate $2.8 million (and most wives would say "there is a problem with this?") Should the wife die, her estate would be exposed to estate taxes of almost $144,000 in 2004 (48% of $300,000 taxable). By Husband leaving Wife $1,200,000 in a Marital/QTIP Trust, Wife's estate will be $1.5 million, resulting in no estate taxes. The balance of Husband's estate ($1,300,000) would go into a Family Trust for wife and their children. The Family Trust passes tax free under the 2004 $1.5 million exemption. The Marital Trust could include a general power of appointment limited in amount which could provide principal access for wife during her lifetime or for H and W's children as needs are determined. No such clause should be placed in the Family Trust.

Husband's above $1.3 million Family Trust is designed to escape estate tax for Wife or other family beneficiaries as well as providing for some of Wife's needs. Since W has no extensive control over the trust and does not create it, it should not be included in Wife's estate. The Family or Bypass Trust is often used for children's benefit and will not be included in their estates.

1. Generation Skipping Transfer Trust (GST)

If the trust passes to their children upon death (.ie, grandchildren) a generation-skipping trust (GST) exists for which a $1 million original funding exemption/limit applies. Most settlers who wish to establish a GST and avoid a gift tax problem may fund the GST with assets up to the estate tax exemption. An amount in excess of the original $1 million exemption is subject to a flat 55% GST tax![8]

2. Dynasty or GST Supertrust

If the Settlor places the exempt $1 million in a GST which purchases $10 million in life insurance on the Settlor, and that amount is professionally managed (invested without lavish distributions), the corpus could be $50-100 million decades later, clearly a "supertrust"! If set up in a friendly forum such as Alaska or South Dakota, the Supertrust could last forever, possibly or until descendents run out or laws change. The Trust should provide for such contingencies.[9]

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[7] *Id.* at 20-24.
[8] American Institute of Certified Public Accountants, *CPA Client Tax Letter*, 4th Quarter 2001, at 2.
[9] *Id.* at 2-3.

C. Crummey Trust

Since the 1968 Crummey case victory for taxpayers,[10] Husband may contribute an amount of $30,000 to a trust which allows Husband's three children to each withdraw up to the annual exempt amount of $10,000 (or more) without gift tax consequences. Why use a trust? The trust provisions allow Husbands to make the contribution in December and the beneficiary children, possibly minors, have a very short period (30 day 'window') to the end of December to withdraw or risk having the amounts become permanent corpus in the trust. Without the Crummey powers of withdrawal, Husband's contributions have to count against Husband's lifetime exemptions. Typically, a Crummey trust for numerous children terminates as the youngest beneficiary reaches age 30 or 35. (GST is used for grandchildren.).[11]

D. Irrevocable Trusts

1. Charitable Remainder Trust (CRT)[12]

- an irrevocable trust to benefit grantor for life with the remainder principal estate/corpus passing to a charity upon the death of all income beneficiaries.
- allows a tax deduction for present value of remainder.
- would want to use a highly appreciated property as corpus.

2. Charitable Lead Trust[13]

- Operates in reverse to the CRT with present income paid to a charity and remainder to heirs or designated beneficiaries.
- Reduces the value of a taxable gift since remainder gift is a future interest.
- Grantor has not retained control or income producing assets, so it is not in his estate at death.

3. Irrevocable Life Insurance Trust[14]

- Set up with "Crummey powers" to pass through assets without gift or estate tax consequences to Grantor.
- Grantor contribution may purchase life insurance which death proceeds provide liquidity for heirs to pay estate taxes for example.

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[10] *Crummey v. Commissioner*, 397 F.2d 82, (9th Cir. 1968).
[11] Alexander A. Bove, *supra* note 3, at 192
[12] See *Overview*, *supra*, note 6, at 4, § 6.
[13] *Id.* at 10.
[14] *Id.* at 11, § 6.

4. Grantor Retained Annuity Trust (GRAT)[15]

- Trust is split into present income flow and future remainder for a specific term of years.
- Creates a fairly certain sum of payments to the Grantor and creates a possible gift tax problem, but the value of the property for tax purposes is frozen at the time the gift to the trust is made.
- Grantor should not add to the trust once annuity is fixed.

5. Grantor Retained Uni-Trust (GRUT)[16]

- Grantor does not receive a fixed annuity as in the GRAT, but receives a "uni-trust interest" wherein the income interest is a fixed percentage of the fair market value of the trust property revalued annually.
- Grantor may add to the trust assets giving it a preference to the GRAT.

6. Qualified Personal Residence Trust (QPRT)[17]

- No fixed income stream because the trust asset is a personal residence; yet, "use" equals income.
- Grantor could use a residence for which the mortgage interest deduction would apply. Thus a vacation house retained for 280 days and lived in at least 28 days annually could fund a QPRT.
- Transfers a future remainder interest to beneficiaries while retaining the use/income stream of the house for the term of the trust.
- Removes the property and its appreciation from the taxable estate if the Grantor keeps the property in the family as future remainder vests a present fee with the beneficiary/heirs.

VI. CONCLUSION

Recent changes in the estate laws provide American taxpayers with the worse possible tax situation. The new law that purports to give relief to small businesses and future heirs by eliminating the death tax is actually a political fraud. The entire scheme sunsets itself back to the future. By declaring that in the year 2011 the elimination of the death tax will revert back to whatever laws Congress will pass in the future, the Congress has essentially bought its compromise by having estate planners enjoy the opportunity posed by complete uncertainty.

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[15] *Id.* at 13-14, § 6.
[16] *Id.*
[17] *Overview, supra* note 6, at 13-14, § 6.

Phase-out schedule for estate tax repeal[18]

Year	Top Estate Tax Rate	Exemption Amount
2002	50%	$1 million
2003	49%	$1 million
2004	48%	$1.5 million
2005	47%	$1.5 million
2006	46%	$2 million
2007	45%	$2 million
2008	45%	$3.5 million
2009	45%	$3.5 million
2010	repealed	All[19]

While most of the trust devices surveyed in this paper offer inheritance tax deferment or relief, their relevance will not diminish under the current estate tax laws. On the contrary, estate planning will have a field day given the uncertainties built into the system. Annual review of estate plans is now a necessity. One of the more complicated issues is to what extent may trusts be written or amended to reflect whatever tax laws are passed in the future. Such an issue was purely academic prior to the passage of the new estate tax laws. Now, however, the issue assumes real relevance.

Even in the event that Congress miraculously recognized the immorality of taxing property that has already been taxed once and permanently discards the estate tax, the trust vehicles or at least some of them would still be relevant estate planning tools. Turning over an entire estate to a child or young adult who does not have the temperament to resist spending the entire corpus or who does not have the background to make sound investment decisions would necessitate the use of trusts. Trusts have been useful devices for planning smooth transition of small to medium sized businesses even without the incentive of punitive estate taxes. Small to medium sized businesses do not want to find themselves dealing with family shareholders who have no understanding of the business. Hence, the use of life insurance to buyout divorced spouses or children of major stockholders or founders will continue regardless of the estate tax issue. Placing shares of stock in trust subject to sale according to specific events such as divorce or death of the principal or founder makes sense in many circumstances.

Trusts may also be written to provide for some degree of "dead hand" control over children. Some trusts contain provisions that restrict income to beneficiaries if they test positive on drugs or do not secure some sort of full time work. These restrictions provide that treatment will be funded but the habit will not be funded!

Trusts have had a surprisingly long history – even longer than the corporate form of organizing business. And, there is sufficient evidence to suggest that their utility is still valuable.

[18] *CPA Client Tax Letter, supra* note 8, at 2.
[19] If Congress does not act, the top estate tax rate becomes 55% with an estate exemption of $1 million.