Trust Basics

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Concepts, Key Terms, and More

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A KEY ESTATE PLANNING GUIDE

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Traditional vs. Modern Trust

Modern Trust Drafting and Planning Different

Traditional vs. Modern Trust

- A traditional trust may have named a spouse as trustee or co-trustee (to permit someone else to make distributions that might discharge the spousal/trustee's obligation of support for children beneficiaries). At some specified age each child would receive an outright equal share of the trust corpus and the trust would terminate. If a child died before the stated age that child's share would be distributed to his or her children in a similar fashion. The trust instrument itself may have been a rather simple instrument.

Traditional vs. Modern Trust

- A modern trust might well differ in many respects. Because of the current very high exemptions of $11.18 million (2018) contrasted to perhaps a $1 million level that existed for many years, it may be imperative that the couple making the gifts have access to the trust assets. Thus, a modern irrevocable trust is more likely to be structured as some type of spousal lifetime access trust then merely as a trust for children.
- The more modern view of asset protection planning for the beneficiaries, which now are more likely to include the spouse and/or settlor, is for long term or perpetual trusts and if the concerns are more than modest for the trust to have situs in a jurisdiction with favorable trust law supporting the asset protection goals, regardless of where the client resides.

Traditional vs. Modern Trust

- The tax dynamics are such that more trusts are structured in tax friendly states.
- Other aspects of the differences between traditional versus modern trusts will be reviewed below. While many of the differences are quite technical, many are qualitative. Too many estate planners dismiss these “soft” issues or ignore them. That is a mistake since as trusts continue for lengthy periods, or perpetually, and society values and family units evolve, addressing human aspects of planning is vital. These soft issues also can be more complex to address then many of the technical tax issues that so many focus on.

Modern Trusts: Single Modern Clients

- The number of single people has grown dramatically. The assumption that planning can rely on a spouse as a source of access to assets in an irrevocable trust, or to be a trustee, is not valid for many clients. Despite some commentators naysaying the use of self-settled domestic asset protection trusts (“DAPTs”) for clients residing in states that do not have enabling legislation, the growth in single clients will necessitate a greater use of DAPTs and variations of DAPTs so single clients can also make completed gifts, use their high temporary exemption before the 2026 sunset, have access to those assets, yet also have asset protection benefits. Without the use of these and other techniques, married couples can readily accomplish these goals with non-reciprocal spousal lifetime access trusts (“SLATs”) but single clients might be precluding from any such planning benefits.

Modern Trusts: Modern Definition of Heirs

- Reproductive technologies continue to advance and stretch the definitions of “issue.” How should child or heir be defined? What can be done to integrate flexibility to deal with future issues that perhaps we cannot even envision today? What definitions of “descendant” should be used? Might a protector or other person be given some latitude to modify the definitions to keep them current with evolving technological options.

Modern Trusts: Modern Clients and Silver Divorce

- Silver divorce is the fastest growing demographic for divorce and, if the trend continues, require rethinking many aspects of trust drafting. When the impact of both aging and silver divorce are considered, trusts created for tax or asset protection reasons earlier in life may present a range of issues in later life. What becomes of spousal lifetime access trusts, inter-vivos QTIP trusts and other irrevocable trusts as clients live later, divorce later and have later-life remarriages? More trusts utilize the concept of floating spouse clauses, a concept that was rarely used in more traditional trusts. How are those clauses to be interpreted considering these societal trends? How should trustees be named, and who should be given powers of appointment, all need to be examined considering these changes. Relying on the permanency of any relationship for planning purposes may not be prudent in most instances.

Collaboration is Key

- The modern irrevocable trust is not merely about drafting, but the process of planning, creating and operating a trust. Collaborative teams are becoming the standard for successful modern trust planning. With income tax being more important than estate tax for most wealthy clients, the client's CPA must be actively involved not only in the planning process but also in the trust administration process. Coordination of asset location decisions by wealth advisers, as illustrated below, requires active ongoing involvement of the wealth adviser. The modern trust cannot achieve its goals unless it is planned, and just as important administered, by a collaborative team. The examples of why this is necessary are considerable.

Financial Planner's Vital Role in Modern Trust Administration

- Clients have existing SLATs that were structured as grantor trusts. Separate life insurance trusts are decanted into each SLAT to minimize the number of trusts and obviate the need for annual gifts and Crummey power notices since the SLATs have adequate assets to pay premiums. Post-2017 Tax Act a non-grantor trust is created that shifts non-source passive investment assets outside the settlor's high tax home state. This was done to avoid state tax considering the state and local tax ("SALT") restrictions that increase the out-of-pocket cost of SALT. Further, the client's house was transferred into an LLC and part of that LLC was transferred to the non-grantor trust so that the trust could take advantage of its own $10,000 SALT limitation by deducting property taxes it paid. The LLC is used to avoid an out-of-state trust from having real property in the home state that would subject the trust to jurisdiction in that home state. Charitable contributions are also paid out of this

Financial Planner’s Vital Role in Modern Trust Administration

- Charitable contributions are also paid out of this non-grantor trust since the deductions will not be lost as a result of the now doubled standard deduction if the settlor had instead paid those personally. This trust has a unique tax profile in that a portion of the income will be tax free because of the planned deductions. None of the income will be subject to state income tax, but the portion above the deductions will be subject to compressed federal trust tax rates. This provides another investment “bucket” that the settlor’s wealth manager can plan for. Fine tuning the investment location decisions (which “buckets” hold which assets that are part of the overall asset allocation) can provide a better net of tax return on the client’s overall portfolio. Without active involvement of the wealth adviser this benefit could be lost.

General Concept's and Considerations

Simplicity and Complexity

- The modern trust is more flexible than the traditional trust. This results in more complex trust instruments and plans. The uncertainties and rate of change described above are reflected in trust documents that try to anticipate future tax law changes and provide different mechanisms to deal with those changes. State taxation of trusts is evolving. Society has grown more complex. Today, only about 20% of American family units consist of a traditional husband, wife and children from that marriage. All of this brings more complex goals to trust planning and more complicated provisions in trust instruments.

Simplicity and Complexity

- The complexity makes it more important to create mechanisms to correct a trust that might prove less than optimal in the future. So a modern trust is more likely to include a provision permitting the trustee to decant (merge) the trust into a new trust thus permitting the trust administrative, and other, provisions, to be improved if advisable. To make the decanting provision practical it might be helpful, if not essential, that a person have the authority to change trustees, situs and governing law for the trust. The significantly increased complexity of the modern trust might also suggest that including a trust protector and providing the protector the power to correct scrivener's errors, might be useful.

Simplicity and Complexity

- Some clients, and even advisers, view simplicity as a goal. The flexibility, protections and tax advantages, of the modern trust cannot be achieved without adding new and more complex mechanisms. It is more important with these modern trusts that advisers play a more active role throughout the process of planning, drafting, funding and administering the trust. With a proactive collaborative advisor team, the client need not have to struggle with the additional complexity. More important, if a client or heir is divorced or sued, the protections of modern trusts might make settling that case “simpler” then had no trust or a less robust traditional trust be used. While planning to minimize taxes is often inherently complex, many clients will gladly trade off more complexity for tax savings. Some may not.

Flexibility

- Flexibility to better deal with changing circumstances, whether societal norms, personal situation, tax law changes and developments in the law is becoming commonplace, and further differentiates the modern irrevocable trust from its predecessors. While the range of provisions to be included will vary based on objectives, consider the following:
- With a new focus on non-grantor trust planning consider explicit mechanisms to turn-off non-grantor status (i.e., to convert the trust to a grantor trust) if the tax laws change yet again.
- Change in situs and governing law provision to facilitate moving the trust to minimize state taxation, take advantage of better state laws, etc. Some clauses expressly permit moving the trust to different countries, not merely different states.
- Decanting language in the trust instrument itself. Although more than 20 states have statutes permitting decanting and that number will likely continue to grow, including express decanting language in the instrument may provide important flexibility to the trustee.

Flexibility

- Broader use of powers of appointment to permit each generation to revise the terms of trusts as assets pass in continued long term or perpetual trusts to the next generation. This can readily facilitate each generation modernizing trusts for future heirs based on drafting techniques at that time. Also, consider broader powers. In many traditional trusts powers of appointment were limited to merely endeavoring to avoid a generation skipping transfer (“GST”) tax by causing estate inclusion. When limited powers were provided they were often limited to descendants of the settlor. But as the definitions of descendants evolves, the family unit continues to grow more complex and diverse, such limitations may prove to severe.
- Techniques to cause estate inclusion to achieve a basis step-up on the death of the settlor or a beneficiary. While clearly the focus of income tax planning for trusts has extended well beyond merely achieving a basis adjustment on death, that remains a critical component of many plans. Attention should be paid to basis issues if a non-grantor trust is included such trusts can’t include a power for the settlor to substitute assets (since that alone would characterize the trust as a grantor trust) so that option for achieving a basis step-up is not used.

Flexibility

- Trust protectors with powers to effectuate changes in the instrument. Be cautious as to the use of terminology and the powers given as different draftspersons may use different terminology and assign powers in different ways. Be certain that if a position requires the person appointed act in a fiduciary capacity that the powers given are appropriate to that classification. For example, a person who is a fiduciary may be precluded from adding a new beneficiary because of the fiduciary duty owed other beneficiaries.
- If the trust is a grantor trust, consider a power to lend to the settlor even if not necessary to grantor trust characterization to provide the settlor to access trust assets.

Charitable Beneficiaries

- Distinguish including charitable beneficiaries from the power to add charitable beneficiaries.
- Evaluate the benefits of including permissible charitable beneficiaries and include the requisite language to comply with Code Section 642(c) requirements for a charitable contribution deduction. This differs from the inclusion of a person authorized to add charitable beneficiaries in the future which will characterize the trust as a grantor trust. Including permissible charitable beneficiaries provides a means to garner charitable contribution deductions if the trust is, or becomes, non-grantor. It also provides a means of facilitating charitable contributions by heirs considering the growing trend of using long term or perpetual trusts for most gifts and bequests.

Situs

- Traditional trusts have tended to be formed in the state where the settlor resides. Many lawyers are familiar with the historic approach of creating trusts in the jurisdiction where they practice and the client resides. However, in many instances, forming a trust in a tax friendly jurisdiction may make sense from the outset. Similarly, moving an existing trust to a better jurisdiction might prove advisable at any point in the life of the trust. Moving to a lower tax state might provide significant annual savings depending on the circumstances. The settlor's home state may have a limited duration for which trusts can last, and it may be preferable to create the trust in a jurisdiction that has a longer-term perpetuities period.

Situs

- The client might own a family business and want to name an independent institutional trustee. That might necessitate a directed trust structure, as discussed below. If the client’s home state law does not permit a directed trust, that factor might require forming the trust in a different jurisdiction. So, the more common use of different jurisdictions in the modern trust might give rise to having to name specific additional fiduciaries or non-fiduciaries in the trust instrument. If the client’s home state has unfavorable laws it might be essential to name an administrative trustee in the desired jurisdiction to have nexus in that state so that the trust can avail itself of the favorable laws or tax rules of that jurisdiction.

Situs

- The opposite side of this discussion might suggest limiting the persons appointed and acting in the client's home state to avoid taxation in that home state or to avoid courts in that state having jurisdiction. This might give rise to another position or technique. For example, settlor, a resident of State A sets up a trust in State B naming an administrative trustee in State B. Settlor named herself as investment trustee and her sister as trust protector. Some commentators have suggested that instead of specifying their names and positions in the trust instrument, the trust specifies that a limited liability company (LLC) formed in State B will fill these roles and the persons are named as manager of that LLC. The theory is that naming the LLC in that role is not equivalent to an individual in State A serving and may minimize the risks of State A asserting tax or legal jurisdiction over the trust.

Directed Trust

- Traditionally the trustee of a trust had control over all investment decisions. But, as explained above, the settlor may have to name an institutional trustee to secure situs in a trust friendly jurisdiction. For example, the settlor might have a long-term relationship to a particular local trust company. The settlor might want to take advantages of the laws of a more trust friendly state, but to still continue the long-term relationship with the local financial institution. The use of a directed trust can permit such a client to have both the advantage of the better state law for the trust and still continue the relationship by naming an institutional administrative trustee in the desired state and having the trust direct the home state long time institution to invest assets.

Directed Trust

- There are other common applications of this technique. If an institutional trustee were responsible for insurance, business holding, and investment decisions generally, the settlor would have less control over those decisions and the costs could be more significant. Further, if the settlor’s plan might include the transfer closely held real estate or business interests to the trust it could be difficult to do so with an institutional trustee since many institutions will not accept the risk of holding a closely held business as trustee. While some institutions will in fact serve as trustee for assets other than marketable securities, e.g. a closely held business or real estate investment, that might not be a desirable option while the settlor is alive and not incapacitated. Some settlors may prefer not to pay the fees to an institutional trustee that would be commensurate with the risks of an institution holding such assets.

Directed Trust

- One solution to permit naming an is to structure the trust as a directed trust. A “directed” trust must be formed in a state which permits this type of trust, not all do. In contrast to a traditional trust where there is one trustee with responsibility for all trustee functions, in a directed trust the trustee functions are bifurcated. The institutional trustee may serve as only a general or administrative trustee. A second person is designated to manage investments, called an investment trustee, although a variety of different titles are used for this role. If the institutional trustee is “directed” to follow the instructions of that investment advisor or investment trustee the institution should have very limited or no liability for that investment.

Directed Trust

- A bit of semantics might be useful. If a trust "delegates" investment management the trustee will still have an oversight responsibility so that may not suffice as a structure for many client situations. In contrast if the trust agreement and state law permit the trustee to be "directed" as to investments, the trustee should not have any liability. Hence, directed administrative trustees may charge only an annual flat fee for serving as trustee, rather than a percentage of assets that may be more reflective of the risks associated of having investment responsibility. It is this modest flat fee that makes this technique viable for a much broader range of clients than how more traditional trusts were structured. So, if a trust is to be structured as a directed trust a number of different positions will have to be incorporated into the trust. These are discussed in more detail below.

Powers of Appointment

- Powers of appointment can and should be integrated into a number of provisions in modern trusts, more so than what was done in a traditional trust. Traditional trusts often only used powers to avoid the unintentional triggering of GST tax. But powers can infuse so much more flexibility and planning capability into trusts. Powers can provide a valuable and flexible mechanism to virtually re-write the trust at each generational level. Given the tremendous uncertainty in the tax, legal and other environments, this can be incredibly useful. Securing an increase in income tax basis on death is valuable to eliminate capital gains on pre-death appreciation. Since capital gains can be nearly as costly (and potentially under some scenarios more costly) then estate tax this can be valuable to consider in the planning process.

Powers of Appointment

- It may be feasible, if your client can designate a trustworthy and reliable relative, that such person could be given a power of appointment. A power of appointment is the right to designate how assets, such as those held in a trust, will be distributed. If that power of appointment is characterized as a “general” power the assets over which it can be exercised will be included in that person’s estate. If that person’s estate is not subject to state or federal estate tax then a basis step-up may be achieved at no estate tax cost. Further, this basis step up may be realized long before the settlor’s death so that the settlor could affirmatively capitalize on this tax advantage during lifetime. If the settlor believes that they could name such a person, but there is concern about granting a general power, several approaches can be used to mitigate its scope without sacrificing the intended tax result. The general power could be a "narrow" general power so that the power holder can only appoint to a designated class of persons and the person’s creditors to cause estate inclusion.

Powers of Appointment

- This limits the scope of the power to lessen its use to appoint assets to those other than who the settlor intended. Also, the power can be subject to the consent of a non-adverse person. More specifically, the person holding the consent power cannot have a substantial interest adverse to the exercise of the power in favor of the decedent, his or her estate, his or her creditors or the creditors of his or her estate. Another approach is for the trust document to grant the right to a person designated in the trust instrument to modify the terms of a limited power of appointment (e.g. to appoint only to the settlor's children and descendants) and convert it to a general power of appointment. For example, the relative involved might only be given the right to appoint to settlor's descendants but the trust protector could be given the right to broaden that power to include the relative's creditors. If your client wishes to pursue this type of planning your client has to identify a potential candidate for holding the power and inclusion as a beneficiary.

Trustees, Other Fiduciaries and Non-Fiduciaries

General Trustees, Protectors, Investment Trustees, etc.

Roles in a Modern Trust

- The numbers and roles of fiduciaries and other power-holders/positions in modern irrevocable trusts has proliferated. One concern is how the people serving in these roles might impact a particular trust. Will a state argue for taxation or jurisdiction because a trust protector resides in that state? If the protector is not acting in a fiduciary capacity would that result differ? Instead of having individuals serve in such capacities a trust instrument might instead name an entity and have the people selected by the settlor to serve in those capacities serve as managers of the entity, e.g. a limited liability company, and act in that capacity. This might provide a buffer to hinder or even prevent states from asserting jurisdiction because of the involvement of a resident of that state.

Roles in a Modern Trust

- For those concerned about asset protection, e.g. the potential for a state to assert jurisdiction based on the residence of a trust protector or investment trustee, this type of planning may be an important safeguard to consider.
- The result of the above techniques is that modern irrevocable trusts can provide significant asset protection, but the variations of techniques is considerable, and the planning team will have to select the appropriate technique based on the settlor's particular circumstances. Also, the trust and plan will have to be monitored so that the persons involved are aware of the powers they hold and know if, when and how to exercise them.

General and Admin. Trustee

- An institutional administrative and general trustee may be designated. This position will hold all trustee powers in the governing instrument that have not been allocated to other fiduciaries. For example, if the trust names a trust protector and investment trustee, the general and administrative trustee will have all trust authority not given to those other two positions. Naming an administrative trustee can permit the client to choose to have the laws of any state apply, while continuing to have flexibility and control over trust investments.

General and Admin. Trustee

- There is some disagreement among commentators whether this approach suffices for a self-settled domestic asset protection trust ("DAPT"). A DAPT is a trust for which the settlor is also a beneficiary but for which the position is that the assets are out of the reach of the settlor's creditors and estate. For example, if the settlor lives in State A which does not permit self-settled trusts, and sets up a DAPT in State B which does, naming a trust company in State B as trustee, not all are convinced that this will suffice to protect the settlor from claims made in her home state against the DAPT.

Distribution Trustee

- The trust could name a person, or group of persons acting as a committee, to be responsible for trust distributions. Caution should be exercised as the power to distribute is a tax sensitive power that could cause trust assets to be included in the power holder's estate if not properly handled. The settlor may be safer in terms of accomplishing trust goals by leaving this function under the auspices of an independent institutional general trustee.

Investment Advisor

- This position has been called by a variety of names including “investment advisor,” “trust protector,” and so forth. A person could be designated to be responsible for investment decisions of the trust. This could include investments of securities and business and real estate interests transferred to the trust (e.g., a closely held business or rental real estate). The settlor might serve in this role but caution is in order. If the trust owns stock in a closely held business the trust objectives might be better served by proscribing the settlor from voting stock.

Investment Advisor

- In some trusts, it might be advantageous to bifurcate the investment trustee provision and provide for a separate trustee to manage marketable securities, which might be the institutional trustee serving, and an investment trustee which may be a family member, to be responsible for family business or other private equity interests.

Insurance Trustee

- It might be advisable to bifurcate the investment trustee provision into several investment trustee positions. A person could be designated to be responsible for life insurance decisions of the trust. This person should not be the insured. By providing for a separate person to be responsible for insurance decisions, and including prohibitions against the settlor/insured being involved in these decisions, the trust can hold both life insurance and other assets. Some of the advantages of this include the ability to use a single trust instead to hold business interests and life insurance, instead of multiple trusts, and the ability to use income generated by trust investments to pay for life insurance premiums. If a new trust is created to integrate these characteristics review existing insurance trusts to determine if they can be decanted (merged) into this new trust.

Charitable Designator

- A person, acting in a non-fiduciary capacity, could be given the power to add charitable beneficiaries. This power will characterize the trust as a grantor trust.
- One of the means of creating grantor trust status is to empower a person to add to the class of beneficiaries, such as a charity. Because none of the powers to trigger grantor trust status are absolutely assured it may be advisable to provide for more than one mechanism. Also, in light of the reciprocal trust doctrine discussed above, it may be advisable when spouses create trusts to use a different power in the second spouse’s trust. With the discussions about restrictions on income tax benefits of itemized deductions and even charitable contributions, perhaps it is advisable to include a mechanism to add charitable beneficiaries in more trusts to provide flexibility for settlors to make contributions out of irrevocable trusts if that proves advantageous in the future.

Trust Protector

- This is a person appointed in a fiduciary capacity (although some commentators disagree and believe the protector can act in a non-fiduciary capacity) to hold important powers over the trust, and perhaps to perform certain other defined roles.
- The protector may be given the power to remove and replace existing trustees, correct scrivener's errors, modify administrative provisions, change trust situs and governing law, the power to restrict or eliminate the right of the Trustee to use income of the trust to pay life insurance premiums on the life of grantor to facilitate turning off grantor trust status if that becomes desirable, and other powers depending on the circumstances and goals.

Power of Appointment Holder

- Powers of appointment should be included to provide further flexibility. Granting someone else the power to transmute limited powers of appointment into general ones can be used to cause some or all the trust assets to be included in an estate to qualify for a basis step up on death could that prove advantageous under a future tax system.

Substitutor = Swap Power Holder

- This person, who may be the settlor or another person, can be given the power to exchange or “swap” assets of the trust for assets of equivalent. This can be a powerful mechanism to move assets between your client personally and the trust if it becomes advantageous, or merely desired, to hold an asset personally that is in the trust, or vice versa. The common application of this technique is to swap highly appreciated trust assets back into the grantor’s estate so on death they will qualify for a step-up in income tax basis.

Substitutor = Swap Power Holder

- For example, if a capital gains tax on death is enacted the swap power may be used in the opposite manner than it has generally be envisioned, namely to move appreciated assets out of the grantor's estate where they might be subjected to a capital gains tax on death into the trust where perhaps they may not be. Provisions should be added to your client's durable power of attorney to address this power in the event of disability. It also is prudent to arrange lines of credit to facilitate acting on this swap power in an emergency situation. Because none of the powers to trigger grantor trust status are absolutely assured it may be advisable to provide for more than one mechanism.

Loan Designator

- Another means of creating grantor trust status is to empower an independent person to loan the grantor/settlor principal of the trust without adequate security. Because none of the powers to trigger grantor trust status are absolutely assured it may be advisable to provide for more than one mechanism. Given the uncertainty of the estate tax, and the economic issues of longevity, it may be advisable to consider a loan provision in many trusts as this may provide another means to provide the settlor a means to access value or cash inside the trust if needed.

Loan Designator

- While grantor trust status can, according to most commentators, be assured with a swap power, perhaps a loan provision should still be included, but now more for providing a means for the settlor to access trust principal than for grantor trust characterization. If the estate tax is repealed the settlor might be more comfortable with the planning knowing that there is a means to provide access to trust funds, even if that is as a loan.

Income Tax Status of a Trust

Grantor; Non-Grantor; GST

Grantor Trust Status

- The default approach for most irrevocable trusts are for them to be structured as grantor trust for income tax purposes. The advantages of a grantor trust include that the income of the trust is taxed to the grantor thereby further reducing the grantor's estate, and providing better asset protection. This status will also permit the grantor to swap appreciated trust assets back into his or her estate so those assets can qualify for an increase in income tax basis on death. Under the current planning paradigm for many this is a critical estate planning goal. Also, grantor trust status may permit the grantor to sell appreciated business, real estate or other interests to the trust without triggering a capital gain.

Grantor Trust Status

- That may prove to be a key to transitioning the client's business to the next generation without tax costs and protecting the business for those intended heirs. However, even for those not subject to an estate tax a note sale to a grantor trust can be a powerful divorce or asset protection planning tool. A common provision included in trusts to achieve grantor trust status is the power to substitute or swap assets. This provision requires a special trust position, sometimes referred to as the "substitutor," for which the settlor will have to appoint a person to serve. The default person named is generally the settlor of the trust, but that is not required.

Grantor Trust Status

- The settlor could appoint another person, such as a sibling of the settlor. Who should be named might depend on the nature of the trust, the assets in the trust and the tax objectives for the trust. There is also a different approach to achieving grantor trust status using what is sometimes referred to as a beneficiary defective irrevocable trust (“BDIT”) in which the settlor creates a trust but the trust is characterized as a grantor trust as to the beneficiary through the mechanism of the annual demand or Crummey power in the trust instrument.

Non-Grantor Trust Status

- Non-grantor trusts may be intentionally formed to provide income tax benefits, e.g.:
- Charitable contribution deductions in light of the high standard deduction.
- 199A 20% deductions from qualified business interests.
- State and local tax ("SALT") planning benefits.
- Property tax deduction benefits.
- ….and more

Dynastic “GST” Trusts

- Trusts should generally be planned so that the assets of the trust will remain outside the transfer tax system, and protected within the trust, for as long as state law permits. As noted above, the future of the tax system is very uncertain. Keeping assets inside flexible trusts for a very long term or indefinitely, can provide more safety and more planning options as the tax system, and other circumstances, evolve. This long-term approach may suggest that the trust be formed outside the client’s home state in a jurisdiction that permits longer term trusts than the client’s home state. Also, the longer the trust the more flexibility that should be built into the instrument. The trend of modern trust drafting favoring long term trusts affects each of the positions designated in the trust as well as the importance of succession considerations for each position.

State Income Taxation of Trust

- An accountant is planning to prepare an income tax return for a modern trust. If the trust has a decanting provision included, as well as a power to the trustee (or others) to change governing law and situs, it may no longer be appropriate to assume that if the trust had been taxable in a particular high tax state that it remains so taxable. Even if it is in fact so taxable for the current year, the flexibility in the modern trust instrument may readily facilitate making changes to the trust and moving it to a low- or no-tax jurisdiction to reduce or avoid state income tax. Is it reasonable for the accountant to merely assume continued taxation in the high tax state? Should the possibility of instituting changes to save state income taxes at least be explored? The decision may not be simple or obvious. What types of assets are included in the trust?

State Income Taxation of Trust

- If some assets are business interests actively operated in the high tax state (source income), there may be no means to shift those interests to a lower tax state. Perhaps a restructure of certain aspects of the business might facilitate shifting some income out of state. If the trust holds both source income and passive investment assets that are not sourced to that state, might it be necessary to divide the trust into two separate trusts and move the non-source asset trust to a low- or no-tax jurisdiction? These decisions may well require input from trust counsel, the trust accountant and wealth adviser.

2038 Estate Inclusion

- **<u>2038 Power</u>**. Obtaining a basis step-up is a key focus of trust planning and having various options to create this result may be useful in planning and drafting trusts. Consider granting someone the ability to grant the settlor a power under Code Section 2038 to cause estate inclusion. The trust could give the trustee, or perhaps a third party acting in a non-fiduciary capacity, a power to grant the settlor the right to control the beneficial enjoyment of trust assets. This would cause estate tax inclusion in the settlor’s estate under IRC Sec. 2038. A corporate trustee may be unwilling to exercise such a power so it may be advisable to grant the power to an individual. Consider giving the power to a non-fiduciary.

2038 Estate Inclusion

- This can provide a mechanism to cause estate inclusion and obtain a basis step up on the settlor’s death if that proves advantageous. It might be advantageous to grant the trustee the right to select which assets to grant this power over. If an asset has declined in value, it may be preferable to avoid changing the basis at death. Caution, if the estate tax is repealed, there will presumably be no Section 2038, so how the step up in basis would be effected under a repeal regime is uncertain.

Asset Protection

SLATs, DAPTs and More

Asset Protection Vital

- Asset protection has almost always been a result, if not a direct goal, of estate planning. The approximately 50% divorce rate, burgeoning of elder financial abuse, malpractice and other litigation for some clients, and other worries, have all supported this. As the estate tax has become irrelevant to many clients, the importance of asset protection has grown in the list of planning objectives. But the waning of the estate tax and the other changes in the evolution of modern trust planning, have changed how asset protection may be integrated into a plan. For many clients the absence of an estate tax benefit could leave the creation and funding of an irrevocable trust with no other justification but asset protection. It is preferable to have other motives to support the planning.

Non-Reciprocal Status of Trusts

- With the high exemptions, longevity and tax uncertainty it has become more common for married couples to structure spousal lifetime access trusts ("SLAT") than merely trust for children or other descendants. In this way, the couple can remain beneficiaries of trusts although the assets in those trusts are arguably outside their estate and secure from the reach of creditors. SLATs may be created by the husband creating a trust for wife and descendants and wife creating a trust for husband and descendants. For SLATs to be effective the trust instruments and plans should be differentiated.

More on SLATs – Non-Grantor SLANTs?

- A common asset protection step for married couples is the creation of non-reciprocal (each trust is sufficiently different to deflect a challenge by a creditor or the IRS to uncross the two trusts) SLATs. A challenge with this plan in the current environment is that the settlors may want (or as in the case of some asset protection require) the income tax benefits of non-grantor trusts. If the settlor's spouse is named a beneficiary that alone would result in characterization of the trust as a grantor trust. But all these seemingly disparate goals can be achieved if the spouse's rights to distributions are conditioned upon the approval of an adverse party. This type of non-grantor trust is a variation on traditional trust drafting that can be tailored to endeavor to accomplish the settlor's goas in the current tax environment (use current high temporary exemptions, make a completed gift, retain access to trust assets, yet have a non-grantor trust for income tax and asset protection advantages).

Non-Reciprocal Status of Trusts

- If the trusts are identical (e.g., all identical terms and merely different names) they may be disregarded under a concept called the “reciprocal trust doctrine.” The preferable approach is to draft each trust from scratch incorporating meaningful legal, tax, and economic differences in each. Differences may include different fiduciary and non-fiduciary positions, different persons named for positions that are the same in each trust, as so on. So, making a couple’s SLATs distinct one from the other will have a significant impact on the positions and persons named in each trust.

Self Settled Trusts for Protection?

- Although the number of states permitting self-settled DAPTs has grown to about 17, the number of cases challenging DAPTs, and the concerns of some commentators have grown. As a result, the variations of the DAPT technique have also grown. Hybrid DAPTs are a common response in which a person is given the power in a non-fiduciary capacity to add descendants of the settlor’s grandparents as beneficiaries of the trust. Unless and until that power is exercised the trust cannot be characterized as self-settled. Prior to exercise the trust might be divided into two with only the power to appoint being exercised over a smaller portion that seems necessary for current access.

Hybrid Domestic Asset Protection Trusts

- Consider hybrid DAPT provisions. If the trust is formed in one of the states that permit self-settled trust as (DAPTs), the client can be a beneficiary of her own trust. However, if she resides in a state that does not permit these trusts, some advisers view it as too risky to create a DAPT in a state that does. But there is a hybrid solution that might reduce the risk some experts perceive, yet leave open the possibility of you benefiting from that trust. Do not name the client initially as a beneficiary. Instead give someone the right to add as beneficiaries of the trust the descendants of the client's grandparents. If the client is not a beneficiary initially the trust should not face that risk. But this may afford the client the possibility of being a beneficiary if he needs access in the future.

Domestic Asset Protection Trusts

- Some practitioners are not comfortable with even a hybrid DAPT approach as they are concerned that if the settlor is even a potential appointee of the trust that could make the trust a self-settled trust and cause estate inclusion under IRC Sec. 2036 because creditors might be able to reach the corpus. These practitioners prefer to create a hybrid DAPT in a DAPT jurisdiction.

LPOA instead of Self Settled Trust?

- Another approach is to have a person hold a power to require the trustee to make a distribution to the settlor, but not to add her as a beneficiary. If the trust is a grantor trust the power to loan (that itself should characterize the trust as a grantor trust for income tax purposes) can be used to provide benefit to the settlor without the settlor being named a beneficiary. Arguably such a trust should not be characterized as self-settled.

Administering the Modern Trust

Flexibility of Modern Trusts Requires Proper Administration

Trust Administration is Vital

- Modern irrevocable trusts require more proactive ongoing attention to administration. The proliferating powers of appointment and fiduciary and non-fiduciary positions, power to substitute, power to loan, potential to change the trusts characterization from grantor to non-grantor or vice versa, potential for change in situs, and more, all require more and regular attention as contrasted to more traditional trusts that had few if any of these flexibilities. The most critical difference in a modern versus traditional irrevocable trust is that historically it had generally been assumed that an irrevocable trust “could not be changed.” In fact, that was how the term “irrevocable” was defined to clients planning irrevocable trusts, often as a caution for them to carefully consider their decisions because they were permanent. With the common use of decanting, non-judicial modifications, trust protector provisions, options to change situs and governing law, and so on, the modern irrevocable trust, while “irrevocable,” can be modified in a myriad of ways.

Trust Administration is Vital

- The vary flexibility that is a distinguishing feature of the modern irrevocable trust creates the imperative for regular trust administration formalities. These should include a periodic, perhaps annual but the frequency will depend on actions taken, trust assets and other factors, meeting of all relevant parties. This should include the advisor team, trustee, trust protector, investment adviser, and others. Modern irrevocable trusts require more proactive ongoing attention to administration. The proliferating powers of appointment and fiduciary and non-fiduciary positions, power to substitute, power to loan, potential to change the trusts characterization from grantor to non-grantor or vice versa, potential for change in situs, and more, all require more and regular attention as contrasted to more traditional trusts that had few if any of these flexibilities. The most critical difference in a modern versus traditional irrevocable trust is that historically it had generally been assumed that an irrevocable trust "could not be changed."

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Communication of Admin Actions

- The need for ongoing proactive administration is much broader than merely the above income tax examples. If a trust protector has the authority to change governing law and situs, will the accountant or other advisers know whether any such action has been taken without confirmation? If someone holds the power to add a beneficiary, can the trustees know for certain whether such an addition was made? Whether or not an action was taken to add a beneficiary, might it be advantageous to do so?

Administering Swap Powers

- The inclusion of powers to substitute (to swap trust assets for personal assets) is nearly ubiquitous in grantor trusts. Can an accountant preparing an income tax return know whether a particular asset is still on the trust balance sheet at year end without confirmation as to whether the power holder has acted? Too often settlors, without appreciating the formalities of trust administration, may gift assets to a trust, or swap assets out of a trust without informing the advisor team. This can be particularly nettlesome in a directed trust when the settlor is also named as the investment adviser as he or she may view it as solely within his or her purview to effectuate a swap.

Administering Swap Powers

- While the settlor may be granted the right to swap assets, the trustee likely will have to confirm that the assets swapped are of equivalent value. What steps are required by the trust instrument to implement a swap? How will the trustee corroborate equivalent values? If the settlor in her capacity as trust investment adviser merely swaps assets, the changes made may not be reflected in a timely fashion on the administrative (i.e., directed) trustee's records. Might such actions be viewed by a claimant, IRS or court as a disregard of the independent nature of the trust?

Reporting to Beneficiaries

- Under some state laws if sufficient disclosures are made to the beneficiaries the time period during which a beneficiary can make a claim against a trustee is then limited. Should reports be so issued? If so, what should be reported? Before issuing any communications to beneficiaries are there special circumstances that the trustee might wish to consider? For example, is a beneficiary in the midst of a divorce and sending the reports to the beneficiary’s home may subject them to interception but the beneficiaries ex-spouse? Are one or more beneficiaries too young to receive reports? Does the trust include provisions making it a “quiet trust” for which disclosures cannot be made? Does applicable state law permit those restrictions? The concept of quiet trusts is generally new and state law continues to evolve.

Reporting to Beneficiaries

- While most if not all institutional trustees have policies and procedures to address communication to beneficiaries, few individual trustees appear to address these matters. For the institutional trustee, at the periodic meeting addressing any unique circumstances that the trustee should be informed of could be important. For the individual trustee, addressing the need to communicate and the potential affect to that individual trustee's potential liability may be important to address.

Administration of Multiple Fiduciaries and Other Holders

- As the number of fiduciary and non-fiduciary positions, and power holders has grown, the need for periodic reviews has become more important. These may include general or limited powers of appointment or more specialized powers to direct a trustee to make a distribution to make a distribution to the settlor or to add a beneficiary and more. It is likely impossible for any trustee or practitioner to recall the nuances of each modern trust without periodic review. Further, many of the people holding these powers, even if properly informed of them at the outset and even if they signed the trust instrument, may not recall or understand the role they play. Further, to make an informed decision as to whether they should act on any of the powers they have, they will require current information and guidance.

Administering a Directed Trust

- In a directed trust, especially if the directed trustee is an institution, likely most or all investment decisions will be corroborated by a written signed direction letter the trustee will insist on. If the trustee is an individual those important formalities may be overlooked. But in addition to that step, what actions and records should the investment adviser who is directing the trustee retain? That person is likely acting in a fiduciary capacity and has a responsibility to the trust beneficiaries even if empowered to make investment decisions.

Administering a Directed Trust

- If the assets held in the trust are private equity, which is often the case as that is the precise reason why the trust was structured as a directed trust, should the investment trustee perform and document some of the same due diligence that an institutional trustee would if they had responsibility for holding that asset?

Conclusion and Additional Information

Even the Basics aren’t Basic!

Conclusion

- Modern trust drafting if a vital component of every planner’s toolkit.
- The flexibility of modern trust drafting can offer clients of almost every income and wealth level valuable planning options.

Additional information

- Contact Martin M. Shenkman via email at shenkman@shenkmanlaw.com

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