More Clients Should Choose Trusts

With good drafting, parents can give children the benefits of a trust and still avoid ruling from beyond the grave

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Until recently, the emphasis in estate planning was on saving estate taxes. But there is more to estate planning than taxes. Even the most sophisticated plan is worthless if clients' assets are lost to a catastrophic judgment. Within the past few years, we have seen wild volatility in the stock market and a staggering increase in individual and business bankruptcies. For many of our high-net-worth clients, the emphasis is now more on wealth preservation than accumulation. The ability to legally protect assets from future creditors might be what distinguishes the wealthy from the bankrupt.

The concept of asset-protection planning seemed novel as recently as 10 years ago. Many thought it limited to offshore trusts and were suspicious of the clients' motives, suspecting tax evasion or fraud. Today, asset-protection planning has more respect. I recommend it become an integral part of every estate plan. But asset-protection planning isn't limited to offshore trusts. It includes the proper form of ownership of assets and business interests, as well as integrating trusts into estate plans.

> Asset protection can include integrating trusts into estate plans.

My experience leads me to believe that the professional advisor community needs to do a better job urging clients to use trusts, rather than making outright bequests. Given today's litigious climate, it is surprising to see that most wills still are drafted to provide for outright distributions upon attainment of certain ages. Drafters might believe they are merely following their clients wishes. I submit that they aren't asking the right questions—or alerting clients to the pitfalls of their choices.

Instead of asking clients when they want children to receive their inheritance, I suggest asking clients if they have any concerns that their children might one day get divorced or face financial difficulties. Might a child ever have to give a personal guarantee to a bank for their business loans? Or choose a career with large malpractice risks? Most clients I advise have such concerns. While the usual reasons for structuring an inheritance as a trust include worries about spendthrift children or disabled beneficiaries, trusts can be a good option even when heirs are neither. It should never be overlooked that trusts can confer tax benefits and protect beneficiaries from future creditors.

Spendthrift trusts can protect assets from a beneficiary's bankruptcy or improvidence as well as future ex-spouses and tort creditors. But if these concerns are not considered or a trust is not properly drafted, good intentions can go awry. For example, in *Drye v. United States*,[1] the court found a disclaimer insufficient to thwart an Internal Revenue Service tax lien. In *Drye*, a mother left her estate to her son outright, apparently failing to realize he had outstanding tax liabilities. Her son disclaimed the inheritance that, under state law, deemed him never to have received it. But the U.S. Supreme Court held that a federal tax lien was a lien on all property rights under federal law, and could not be affected by a disclaimer.

Another common drafting error is to create a trust for a term of years (such as a grantor retained annuity trust) and provide that, upon the end of the initial term, the trust terminates in favor of the grantor's issue. In *Dryfoos v. Dryfoos*,[2] a Connecticut court held that, because one spouse had a vested interest in the remainder, his soon-to-be ex-wife was entitled to 30 percent of it. The entire corpus would have been protected from divorce claims had the grantor provided for a continuing trust for her son's benefit.

Other common drafting errors include using the phrase "the trustee shall make distributions for the beneficiary's health, welfare and maintenance." Even where such distribution is expected to be in the trustee's absolute discretion, at least one court has held that the trustee's discretion is limited to determining the amounts they "deem necessary for the taxpayer's proper care, maintenance and support. The provision that the 'trustees shall pay' is mandatory and conveys an intent of the testator that his son is to receive support payments. . . if he needs support."[3] Perhaps a different result would have been obtained had the drafter used the phrase "may make distributions" instead of "shall make distributions." Choosing the wrong trustee may present problems of its own. For instance, if the beneficiary is the sole trustee of a trust providing him with discretion to distribute for his own health, welfare and maintenance, such assets could be available to the beneficiary's creditors.[4]

For ultimate flexibility, give the trustee discretion to end or revise the trust.

TRUSTEE CONTROL

Despite trusts' asset-protection advantages, many clients react negatively or reluctantly when an advisor suggests creating one. Some

HOLD-BACK CLAUSE

If the Trustee shall, in the exercise of sole and absolute discretion, determine that circumstances exist making it clearly contrary to the best interests of a Beneficiary to receive a distribution of principal which is otherwise required to be made hereunder, the Trustee may refrain from making all or any part of such distribution until the Trustee determines that such circumstances no longer exist. Circumstances in a Beneficiary's life that would justify exercising that discretion include, without limitation, being a defendant in serious litigation or being involved in bankruptcy proceedings or similar financial or matrimonial difficulties, being physically, mentally or emotionally unable to properly administer the assets to be distributed, or living under a form of government or other condition making it highly likely that the assets to be distributed would be subject to confiscation or expropriation.

clients don't want to be perceived as ruling from the grave. Some fear potentially uncooperative trustees, not to mention costs and administrative complexities. A planner's role then is to educate clients on how trusts can be drafted to balance the need for asset protection with the desire to give beneficiaries the degree of control that comes with outright ownership.

A trust's vulnerability to creditors is generally dependent on three factors: a beneficiary's retention of control, an ability to use a power of appointment and withdrawal or invasion rights. For maximum asset protection, trusts should provide for independent trustees; the right to receive income or principal distributions in the trustee's discretion; the power to make payment on behalf of beneficiaries rather than directly to them; the authorization to acquire assets for the use and enjoyment of the beneficiaries (for example, home, art, etc.); the power to hold back distributions if adverse to a beneficiary's interest; the inclusion of sprinkling beneficiaries; and a spendthrift provision.

A drafter must balance such provisions with a client's desire for maximum flexibility. As it is difficult to predict either an individual's future or the changing tax and administrative environments, a trust requires maximum administrative flexibility. Even the needs of first generation beneficiaries (for example, the grantor's children), are uncertain, especially if the beneficiaries are young and/or still developing socially or professionally. Although reformation of the trust through court proceedings may be possible, such proceedings can be costly and unpredictable.

Because the trustee acts, in some sense, as a surrogate to the grantor (especially during the grantor's lifetime), subject to fiduciary and tax concerns, the trustee's powers over trust property should be as close as possible to outright ownership of such property. Giving a trustee broad powers over the property is the best way to make sure a trustee can handle unanticipated circumstances. If those powers are unfettered, however, the trust property might end up included in the trustee's estate. And if one of the permissible beneficiaries is a dependent of the trustee, the trustee's power to distribute to that beneficiary must be limited to avoid any potential distribution that could supplant the trustee's legally enforceable support obligation.

The trustee also should be encouraged to make loans to a beneficiary, rather than distributing the trust property outright. When distributions are appropriate, the trustee should be given the power to sprinkle property among the beneficiary and his children. A sprinkle provision among the beneficiary and his descendants allows a grantor's remote descendants to enjoy the trust property before the parent beneficiary dies.

OWNERSHIP BENEFITS

If a client's objective is to provide the benefits of outright ownership, it might make sense to include a beneficiary's spouse as a discretionary beneficiary of the trust during and after the beneficiary's lifetime. In addition, if creditor claims make it inadvisable to distribute trust property directly to a beneficiary, a spouse can use trust distributions for the mutual benefit of himself and the beneficiary (for example, for the payment of rent on the family residence). Notwithstanding the potential to continue property in trust well beyond the lifetime of a grantor's grandchildren, some clients wish to provide for distribution when grandchildren/beneficiaries reach a certain age, or alternatively, in set sums or shares when they reach certain ages. Clients typically choose these ages based on a best guess about when their beneficiaries will be mature enough to receive the money. But unanticipated circumstances may reduce or negate the benefit of distribution of trust property to the intended beneficiary. For example, at the time of a required distribution, the beneficiary may be in the midst of a bankruptcy proceeding, subject to the claims of creditors (including spousal claims) or the recipient of governmental and/or other social service benefits that are based on financial need for eligibility purposes (such as Medicaid). Furthermore, unanticipated growth of trust property may result in larger distributions than the grantor intended.

One possible solution is a "hold-back" provision, which gives the trustee the power to withhold any mandatory distribution of trust property if he determines that the distribution would be adverse to the best interests of the beneficiary. Because a hold-back provision gives the trustee—as opposed to the beneficiary—the discretion to make distributions, it should protect the beneficiary from all creditor claims. (See "Hold-Back Clause," page 33, for a sample provision).

A grantor can achieve ultimate trust flexibility by giving the trustee the discretion to discontinue the trust or revise the beneficial interests. Reasons for terminating the trust can include: the trust principal is too small to warrant continuation; the potential repeal of the estate tax may negate the need to continue generation-skipping transfer tax exempt property (although consideration should be given to the tax's reinstatement); and the end of the family line. Also, the grantor's relationship with one or more beneficiaries may change for the worse after the trust has been funded. On the other hand, the grantor may wish to provide for an individual who is currently a non-beneficiary out of the trust property. The grantor may divorce or be widowed and later re-marry, and wish to benefit his new spouse and/or step-children. The grantor may wish to benefit certain of his beneficiaries' spouses or significant others, but not all. To allow such revisions the trustee (or "protector") can have the power to revise the trust's beneficial interests, without causing inclusion of the trust property in the grantor's estate. (See "Changing Beneficial Interests," this page, for a sample revision provision.)

Given that clients may be uncomfortable providing such broad discretion to a trustee, consider limiting the trustee's power to revise the beneficial interests by allowing such power to be exercised only during the lifetime of the grantor and, perhaps, his spouse. Consider further limiting the trustee's power to revise beneficial interests so that only certain classes of individuals may be added as trust beneficiaries (for example, individuals related by blood or marriage to either the grantor or his descendants).

Property from a discontinued trust should be made payable either to one or more of the trust beneficiaries, or to any other trust created by the grantor for any one or more of the beneficiaries. One of my clients had previously established an irrevocable insurance trust that owned approximately $65 million of potential death benefit proceeds. The trust mandated distributions to the grantor's children upon his and his spouse's deaths. Unfortunately, the children had all served on a board of a public company and were named as defendants in numerous lawsuits. Had the trust allowed the trustee to distribute the policies to another trust established by the grantor, the proceeds might have been preserved in trust for the children's' lifetimes. In the end, a solution to this potential calamity involved selling the policies at their current value to another grantor trust

CHANGING BENEFICIAL INTERESTS

The Trustee shall have the following powers with regard to the beneficial interests hereunder:

a. Exclusion of Benefit. The Trustee may, in the exercise of sole and absolute discretion, by a signed declaration in writing declare that the person or persons or members of a class named or specified (whether or not ascertained in such declaration) who are, would be or might be or become (but for this provision) a Beneficiary hereof: (i) shall be partially excluded from future benefit hereunder; or (ii) shall cease to be a Beneficiary hereunder. Any such declaration may be revocable during the continuance of this Trust or irrevocable and shall have effect from the date specified in the declaration.

b. Addition as Beneficiary. The Trustee may, in the exercise of sole and absolute discretion, by a signed declaration in writing revocable at any time or times during the continuance of this Trust or irrevocable, add to the class of Beneficiaries any person or persons or class or classes of persons (other than a Trustee, a Trustee's estate, a Trustee's creditors, or the creditors of a Trustee's estate). Any such addition so made shall name or describe the person or persons or class or classes of persons to be thereby added and shall specify the date from which such person or persons or class or classes of persons shall be so added and the period for which he or they shall be added.

AMENDING A TRUST

The Trustee shall have the fiduciary power, acting alone [or with consent of the Trust Protector], to amend the Trust Agreement in any manner which the Trustee considers, in the exercise of sole and absolute discretion, to be for the benefit or in the interests of one, more or all of the Beneficiaries or their descendants. The Trustee shall also have the power to make technical or conforming amendments in or to the powers, discretions or provisions of this Trust as the Trustee may consider necessary or desirable to complement the overall estate plan of the Grantor.

that had the appropriate provisions.

Another way to preserve flexibility is to provide a trustee (or a third party) with the power to amend the original trust agreement. This is especially useful given the uncertainty regarding the estate tax. (See "Amending a Trust," page 35, for a sample provision.)

BENEFICIARY CONTROL

One way to give a beneficiary the power to dispose of trust property is by giving him a power of appointment—also sometimes known as a "power of disappointment." A testamentary limited power of appointment is a power exercisable by the beneficiary upon his death, generally by execution of a will with a specific reference to the trust provision that grants the power. It vests the beneficiary with the power to adjust the distribution of remaining trust property based on the circumstances existing at the time the power is exercised. If a beneficiary has a limited-power of appointment over trust property, the property isn't taxed as part of the beneficiary's estate. Normally, the beneficiary's power of appointment is limited to an exercise in favor of the grantor's descendants, in order to maintain the trust property within the family line. However, consideration should be given to expand exercise in favor of spouses, other individuals (for example, significant others) or charities, particularly if the alternative was to make an outright disposition to the power holder.

CORPORATE TRUSTEE?

Clients who are concerned that an institutional trustee might not follow their wishes, might appoint as trustee close friends or relatives. A grantor can name a relative as trustee and still cede dominion and control. But if a trustee is or may become a trust beneficiary, a drafter must incorporate special limitations into the trust to prevent it from being included in the estate of the trustee/beneficiary.[5]

If clients are considering creating a dynasty trust—one that theoretically will last for generations—they should strongly consider using a corporate trustee, or at least co-trustee. A corporate trustee's longevity permits continuity of fiduciary governance of trust, provides the client with reasonable certainty as to the identity of the trustee and ensures professional asset management and greater likelihood to strictly comply with standards of fiduciary conduct. Utilizing an out-of-state trustee may also provide relief from state income taxation on the trust's income.

Clients are often ambivalent about institutional trustees—particularly when a trust will continue indefinitely. Later generations of beneficiaries are unlikely to have the same relationship with the trustee as the grantor; key individuals employed by the named corporate fiduciary may leave. In addition, clients might have heard war stories from friends and relatives who were faced with intransigent trustees; they may also mistakenly believe trustee fees are too expensive. To mitigate such concerns, the trust can provide for a "protector" who is vested with the power to oversee the trustee's administration of the trust. Most importantly, the trust protector could have the power to remove and replace the trustee. An ability to remove and replace the trustee does not rise to the level of a right to affect beneficial enjoyment.[6] (See "Protector Provision," this page, for an example.)

With proper attention to detail, a planner can assist a client in achieving the dual objectives of wealth preservation for future generations while providing the flexibility usually found only with outright ownership.

PROTECTOR PROVISION

The Protector shall have the right to remove any Trustee of a trust under this Agreement and appoint a corporation with fiduciary powers or an individual who is not a "related or subordinate party" within the meaning of Section 672(c) to replace the removed Trustee. If the office of Trustee of a Trust becomes vacant, the Protector may appoint a corporation with fiduciary powers as Trustee to fill the vacancy. The Protector may resign. The Protector may release the Protector's power to remove a particular Trustee and such release may be limited to the releasing Protector or made binding upon any successor Protector. The Grantor is not imposing any fiduciary responsibility on the Trust Protector to monitor the acts of the Trustee. The Trust Protector shall not be liable for failing to remove a Trustee even if the Trustee may be guilty of a gross violation of its fiduciary duties hereunder.

Endnotes

1. 528 U.S. 49 (1999).
2. 2000 Conn. Super. Lexis 2004 (Conn. Super., 2000).
3. See U.S. v. Taylor, 254 F. Supp. 752, 755 (N.D. Cal 1996).
4. See, for example, *Est. of Flood*, NYLJ March 11, 1998, Surr. Ct. Nassau Cty. In re: George McCoy 2002 U.S. Dist. Lexis 13239, (N.D. Illinois, 2002).
5. A beneficiary's power to make discretionary distributions to him or herself without an ascertainable standard limitation is a general power of appointment under IRC Sections 2041(b)(1)(A) and 2514(c)(1).
6. IRC Section 2036(a)(1). See, for example, *Wall v. Com'r*, 101 T.C. 300 (1993); Rev. Rul. 95-58, 1995-36 I.R.B. 16.
7. Alaska Stat. Section 13.36.370 (Michie 2003); Del. Code Ann. Tit. 12, Section 3570 (2003); Idaho Code Section 15-7-501 (Michie 1999); S.D. Codified Laws Sections 55-1-1B-1, 55-1B-4 to 55-1B-7 (Michie 1997).
8. See Alexander A. Bove, Jr., "The Trust Protector: Trust(y) Watchdog or Expensive Exotic Pet?," 30 *Est. Plan.* 390 (Aug. 2003).