A short course in trusts and estates for non-lawyers including key players, trust types, trustee duties and major pitfalls

Building a House of Trusts

Table of Contents

Introduction

This would be a word from the author, giving an overview of the material and why the book has been written.

The Basics of Trusts

What is a trust?

A **trust** is a legal entity that holds property or assets for the person who created it—known as the **grantor, settlor, trust creator,** or **trustor** – for the eventual benefit of someone else: the **beneficiary(ies)**.

Trusts and **wills** are the main means of estate planning in America. Large estates are subject to estate taxes. Trusts can reduce that liability by getting assets out of the grantor's estate. In general, the purpose of trusts and wills -- of all estate planning -- is to defer federal and state income tax liability for as long as possible, while allowing the assets to grow as much as possible.

Reasons for Establishing Trusts

In recent times, the main reason for establishing trusts has been to minimize taxes: federal and state income, inheritance/estate, gift, generation-skipping transfer, and fiduciary income taxes. Most specific types of trusts, then, are defined, initially, by their tax benefits.

However, trusts are created for other reasons as well:

- To control/direct/distribute wealth, and protect it from creditors and irresponsible beneficiaries,

- To maintain privacy, and
- To avoid probate.
- Estate and gift taxes

Each American citizen taxpayer has an exemption of $5.34 million for taxable gifts and his estate. Gifts and estates below the exemption limit are generally exempt from transfer taxes—estate, gift, and generation-skipping. If the taxpayer makes taxable gifts during his lifetime, they reduce the exemption. The reason for gift tax is that, otherwise, taxpayers could forestall estate taxes entirely merely by giving away their assets within their lifetimes.

Spouses can combine and shift their exemptions, so that they can exempt a total $10.6 million between their estates. Amounts in excess of these limits are taxable at up to 40% upon death, but a married taxpayer can give his/her US citizen spouse any amount, exempt from tax.

Flexibility vs Control

The goal is to structure the trust document tightly enough to make sure the grantor's intentions will be carried out, while also providing enough flexibility to be able to adapt to changes that the grantor may never have envisaged.

At the other end of the continuum is **dead-hand control,** sometimes called control from the grave. When a trust incorporates dead-hand control, imposing rigid conditions on the trustee and/or beneficiaries, matters can often wind up in court. If that happens, everybody loses: It's the worst-case scenario.

Many trusts established 30 years ago or more provided exceptions specifically only for payment of taxes. These days, most newly formed trusts explicitly make exceptions for "medical emergencies." But that only raises the question: What constitutes an emergency? Surely open-heart surgery does—but what about rhinoplasty?

In the end, such considerations often boil down to giving cover to the trustee--especially a corporate trustee, who seeks to avoid liability at all costs--to make decisions without feeling a judge's blessing is needed.

In designing a trust, the grantor's intent is pivotal, but conveying it in a trust document can be daunting. It involves more than a mere expression of the grantor's wishes. Often the tax implications get paramount consideration--and sometimes, lawyers forget about other things. Taxes should not be allowed to override other important goals.

The grantor and his attorney must consider options for fulfilling his intention, the specific language of the document, how others will interpret it, and the limitations it places on the trustee, who is responsible for implementing it. As we've said, this raises constant tension between flexibility and control.

Grantor vs Non-Grantor Trusts

Grantor and non-grantor trusts are the two primary types of funded trusts, and the relationship of the grantor to the other individuals in the trust determines whether it is a grantor or non-grantor trust. A third type of trust, the intentionally defective grantor trust, contains elements of both the grantor and non-grantor trusts.

In a **grantor trust,** the trustor retains certain powers over the trust and, because of this, the trust's income remains taxable to him. After the grantor dies, a grantor trust loses that status. If the trust continues to operate, the trustee must begin filing income tax returns for it, as a distinct entity.

In non-grantor trusts, the grantor has given up all right and interest in the principal, and only the trustee may terminate the trust. In a non-grantor trust, the grantor cannot be named as a trustee, beneficiary or remainderman. Grantor trusts and intentionally defective grantor trusts become non-grantor trusts at the grantor's death.

In an intentionally defective grantor trust (IDGT), the grantor makes an irrevocable gift of property into a trust, names someone else as trustee and retains the right to substitute other assets of equivalent worth for the property initially put into the trust. Unlike grantor trust tax requirements, the property is effectively moved from the grantor's estate and into the trust. Gift tax is paid on the assets when moved into the trust. No estate tax is due when the grantor dies.

Grantor Trust Tax Implications

Some of the tax consequences of the grantor trust structure are:

Income tax - A grantor trust is a disregarded entity for income tax purposes. This means that any taxable income or deduction earned by the trust will flow onto the grantor's individual income tax return.

Gift tax – A grantor often makes a gift when funding the trust. For tax purposes, this is treated as a gift to the beneficiary(ies). No gift tax return need be filed if the amount is less than federal exclusions, and beneficiaries are notified of the right to withdraw each time a transfer is made, under a provision known as a **Crummey Withdrawal Right** (see page 21). But if the cumulative lifetime amount of the donor's gift(s) exceeds the $5.43 million gift tax threshold, the grantor must file a gift tax return (IRS Form 709). There is one common exception: each taxpayer may give any number of recipients up to $14,000 per year in gifts, which are disregarded for gift tax purposes.

Estate tax – If the grantor retains the power to revoke the trust, its assets will be included in the grantor's gross estate for federal estate tax purposes.

Generation-skipping transfer tax (GSTT) – The grantor's generation determines when the "skip" happens. See page 17 for more on this.

Revocable, Irrevocable, or Somewhere in Between?

Another important feature of trusts is whether they are revocable or irrevocable. Both types of trust are set up while the grantor is alive. The basic distinction is whether you can change your mind about assets you put in the trust.

While the grantor is alive, he can change the terms of a revocable trust or dissolve it entirely. He is considered the taxpayer, and uses his Social Security number to report taxable events. So, revocable grantor trusts ordinarily have no tax advantage; their purpose instead is to enable the estate to avoid probate. They can be a substitute for wills. Putting the grantor's assets in a revocable trust can help protect his privacy. That's because assets that are governed by wills are generally subject to probate, which is public record.

The concept of irrevocable trusts is that once property is put into the trust, it cannot be taken out. These days, almost no rule is iron clad, and we will get into detail on those maneuvers later. (See page xx) Quite commonly, revocable trusts are written such that they become irrevocable upon the grantor's death.

Beneficiaries

Beneficiaries In General

Many trusts have only one beneficiary, or one category of beneficiaries. More complicated trusts may involve both **income beneficiary(ies),** who are entitled to income generated by assets held in the trust, and a **remainder beneficiary(ies),** also called **remaindermen.**

A remainder beneficiary(ies) is entitled to receive the assets of the trust, once the interests of the income beneficiaries have been fulfilled. Having both types of beneficiaries is a way to give greater flexibility and control to the grantor. Even after the primary beneficiary(ies) no longer needs the assets, the grantor dead or alive still controls what ultimately happens to them.

If the trust document says, "I leave the remainder of my estate to my trustee, to hold in trust for my wife for life, remainder to my children equally," the wife is the current/income beneficiary; the children are the future/remainder beneficiaries.

This arrangement can give rise to conflicts because current beneficiaries tend to want maximum current benefits, while remainder persons want to make sure assets are preserved or grown.

Vested and Contingent Interests

A **vested interest** is a current right that cannot be taken away, unless some "condition subsequent" comes into effect. An example is: "Child A shall receive the balance of the remaining trust principal upon reaching age 45." At age 45, Child A's interest is vested.

A **contingent interest** is a right in the trust that *could* come into force in the future, if a "condition precedent" is met. Suppose the trustor leaves $100,000 to his grandson, provided that the grandson gets a bachelor's degree. Attainment of the degree is a **condition precedent**: it must happen before the $100,000 becomes vested. Once the grandson gets his degree, it converts from a contingent interest to a vested interest.

If the trustee shall pay the income of the trust to child C at least quarterly for her lifetime, with the reminder to child D if he survives her, that's a combined vested and contingent interest. Child C's income interest is vested, and D's remainder interest is contingent upon his surviving C.

By contrast, if the trust stipulated that the remainder goes to D no matter what, D's estate would receive C's interest even if C outlives D. Then both would be vested interests.

The distinction between vested and contingent beneficiaries determines their standing with the trustee. A vested beneficiary can discuss all trust administration matters with the trustee. But a contingent beneficiary has no immediate right to involve herself in the administration of the trust.

Another type of interest is **vested, but subject to forfeiture by condition subsequent**. An example: My husband shall receive all the trust income until he remarries.

Beneficiaries' Rights

Beneficiary rights begin with those specified in the trust instrument itself. They might include:

- Income for life
- Certain amounts at stated ages
- The remainder of the assets upon some event (e.g., death of a prior interest holder)
- The right to occupy certain real property
- The right to make trust property productive of income (in a QTIP Marital Trust, this right is mandatory, to preserve the estate tax marital deduction. See page 15).
- Other beneficiary rights are bestowed by state or trust law. The first is the right to be informed about the status of the trust. This includes receiving annual trust accounting reports. Estate law rules specify when trustees must obtain beneficiaries' consent. Also, consent may be required or advisable for major events, such as changes in investment allocation, sale of significant assets such as a family business, and "decanting" (see page 13).

For trustees, the practical need is proof that they have informed the beneficiaries. The best proof is to get a receipt or acknowledgement.

Beneficiaries' Responsibilities

Much has been written about beneficiaries' rights, little about their responsibilities. However, beneficiaries, especially current beneficiaries, are responsible for being informed and taking an active role--as opposed to complaining if things go awry later. Beneficiaries are well advised to take the time to learn about investments, distribution policies, and trustee rights, responsibilities, and discretion. They also should keep trustees informed about their address, marital status, children, and so forth. Of course, a trustee can encourage beneficiaries in this regard.

Trustees

The Trustee: Types, Duties, and Powers

The main types of trustees are individuals, bank/corporate trustees, and family trust companies. The trustee's main duties include administration, loyalty, impartiality, prudence, taking control of trust assets, and, as discussed above, keeping beneficiaries informed.

An individual trustee may be well-informed about family members—including the grantor, and his intent and objectives for the trust—family relationships, and idiosyncrasies. If he serves as trustee only for a single trust, or a single family, he may be loyal, and have plenty of time to devote to trust matters. If he is a family member, the fact that he has his own interests at stake may give him incentives to do a good job managing the interests of his relatives as well.

On the other hand, perhaps no family member is suited to being an impartial, knowledgeable, capable, and affordable individual trustee. Also, the trust may outlive an individual trustee, raising succession issues.

A bank or corporate trustee may be much more knowledgeable and professional than an individual, especially a family member, and well-suited to administer the trust for its entire duration. If litigation arises concerning malfeasance, such a trustee is likely to have deep pockets, and be able to pay a judgment or settlement.

On the other hand, employee turnover within corporate trustees can be a disadvantage, and, even with longevity, a hired commercial trustee may have little intimate knowledge of family members. Corporate trustees also tend to have inflexible administrative and investment policies. For example, they may be unwilling to invest trust assets in what they consider exotic vehicles, especially illiquid ones—a small business, for example—even though they may be among the assets the grantor left to the trust. Finally, they may charge high fees, especially for small trusts.

A family (private) trust company is a sort of hybrid of the other two types. It blends the benefits of the individual trustee's intimacy with the family and a formal process and succession planning. It can manage any sort of assets the family wants. But it can be expensive to set up and administer, and it requires compromises among family members that, in some cases, may be impossible to achieve.

Default Powers of Trustees

The trustee is the party the grantor designates to administer the trust. Each state has laws governing the powers and responsibilities of trustees. These laws come into play for issues on which the trust is silent.

To make sure the trustee can manage the assets and discharge his duties in the manner the grantor sees fit, the trust terms usually include powers such as:

- Managing real property
- Investing
- Allocating between principal and income
- Managing business operations
- Collecting insurance, and
- Filing lawsuits on behalf of the trust.

Establishing the terms of a trust means dealing with the constant tension between flexibility and control. Ordinarily, the grantor's intent is paramount, but the trustee, especially a corporate trustee, usually has broad discretion to administer the trust, as long as the terms of the trust are followed. Corporate trustees often have legal departments for advice on tricky issues.

Without flexibility, if only one beneficiary disagrees with the trustee's actions, litigation could result—which can eat away at the trust's assets, sometimes by 10% - 40%. That is why the trust terms must allow for the trustee's discretion. This is especially important for so-called **dynasty trusts** (see page 22), which can continue to operate for hundreds of years.

The Law, the Trust and the Trustee's Duties

Many states have adopted what is called the **Uniform Trust Code** to govern trusts. In UTC states, getting consent and/or releases from the beneficiaries can help modify or delete terms. In such cases, though, careful attention must be paid to the tax consequences of any changes.

Those states that have not adopted the UTC follow **common law**. Common law is derived from cases dating back centuries in England. In common-law states, the tendency is for disputes over trusts to be settled in probate court—even though the very reason the grantor established the trust in the first place may have been to keep his assets out of probate. Trusts in those states tend to be less flexible, involving more direction and detail.

By contrast, in UTC states, the tendency is to avoid going to court, by having modern, flexible trust terms.

Usually, however, whether in a UTC or common-law state, the terms of the trust document overrule state law: the grantor, in general, gets his way. For example, a trustee can disregard the presumption in favor of diversifying assets—ordinarily, a key principle of prudent investing--if one purpose of the trust is to preserve ownership of a family business.

Only certain "core" trustee duties can't be overwritten in the trust, including the duties:

- To act even-handedly among beneficiaries;
- To act with reasonable care;
- To avoid conflicts of interest;
- To deal fairly with the trust property;
- Not to deal on one's own behalf with trust property;
- Not to earn unauthorized profits; and
- To preserve the confidence of the beneficiaries.

In a 1997 case, *Armitage v. Nurse*, a United Kingdom court upheld an exemption clause that relieved trustees of liability for all breaches of trust, except fraud. U.S. state law will establish default rules which apply in cases where the trust document is incomplete.

The many boilerplate clauses in a typical trust agreement ensure certainty, flexibility, convenience, and direction to the parties. Certainty means what each party may and may not do. Flexibility is the capacity of the trustee to make certain choices based upon the circumstances. Convenience refers to including all of the important information on rights, duties, powers, and responsibilities in the document. Direction is the parameters for the trustee to carry out the duties and interact with the parties.

All of this enables lawyers to sort through unforeseen circumstances more easily.

Trustee Duties

Duty of Administration

The trustee must administer the trust in good faith, in accordance with its terms and purposes, as well as the interests of the beneficiary(ies). That means following the grantor's instructions in the trust agreement and being guided by the grantor's intent in all decision-making. Even so, the trustee sometimes needs to serve as a sort of fulcrum between grantor and beneficiaries.

The trustee must act in good faith. That means doing no harm, and tending to business—not being negligent. Most trust documents include a clause that hold trustees harmless for honest mistakes. But trustees who abdicate their responsibilities—for example, neglecting to file tax returns, or to monitor the actions of their investment advisors—are failing in the duty of administration.

Duty of Loyalty

A trustee must administer the trust solely in the interests of the beneficiaries. He must put beneficiary interests ahead of his own. He cannot use trust assets for his own benefit (unless he is also a beneficiary; special rules govern that situation). He also is forbidden from commingling trust assets with his own. Nor should he lend his own money to a beneficiary of a trust he administers, nor co-invest his own funds with trust assets.

With family offices and trust companies, gray areas frequently arise, because everybody has his fingers in a lot of different pies. If a trustee is found to be profiting at the expense of the trust, or its beneficiary(ies), that's considered one of the most significant breaches of her duties.

Duty of Impartiality

If a trust has multiple beneficiaries, the trustee must act impartially among them in administering the trust property, giving due regard to each of their interests. He may not favor one beneficiary over another, unless the trust terms explicitly permit or authorize this.

Many older trusts state that the current beneficiary is entitled to all of the trust's income every year. Even so, the trustee may not invest too much in high-yield assets, just to maximize income, if doing so compromises the interests of the remainder beneficiary(ies). Instead, he must balance the investments between growth and income. The duty of impartiality bars the trustee from favoring the current beneficiary, just because he complains the loudest.

Until the 1990s, trust investment directives were generally quite rigid. Trustees usually strove to preserve the principal; they gave the income generated to the current or income beneficiary. The primary goal was to preserve capital, not grow it, and trusts were often required to invest 60% in equities, 40% in bonds. About 1993, "little old ladies" who were living on trust income began to have trouble making ends meet, because the investment policy was so conservative.

More recently, modern portfolio theory has come to be applied to trusts. The idea is that trying to maximize *total* return can ease tension between the two types of beneficiaries.

Even so, some income beneficiaries seek to control or influence how the trust principal should be managed. They might want the trust to be invested entirely in municipal bonds, to minimize their tax burden. However, that would also limit the growth potential of the assets. So a trustee, weighing her duty to the remainder beneficiaries, might refuse. She must keep an eye on the future, as well as the present: make sure that the assets being used by the current beneficiary are not reducing the principal for the long term. This has been a source of litigation.

Now, many states allow trustees more discretion in asset allocation. They allow the trustee to say, for example, "I'm going to invest for the long term, and pay 3% a year to the current beneficiary(ies)—but otherwise, not worry about income."

Duty of Prudence

A trustee must administer the trust as a prudent person would, while considering the purposes, terms, distribution requirements, and other circumstances. This is often referred to in shorthand as the "prudent investor" rule: investing for reasonable growth with minimum risk.

It's the responsibility to exercise reasonable care, skill, and caution.

The practical consequence of this rule is to adhere to modern portfolio theory, and generally maintain a fully invested (that is, little or no idle cash), risk-balanced portfolio. This bars investment in many asset classes traditionally deemed "risky" or "speculative." In particular, high concentrations of any one asset or class are prohibited.

Many trusts waive the duty of prudence for the trustee, because the law on "prudent investments" is out of date. It hasn't kept up with modern investment needs, techniques and products. Instead, the standard for trustees has become: produce a reasonable rate of return on the assets.

The issue of prudence generated a great deal of case law, far back in time. As we've said, long ago, the goal of trust administration was understood to be preservation of capital, rather than generating income or growth. Eventually, lists of approved investments emerged; surprisingly, they omitted corporate stocks at one time. Then, lists got longer and longer. Of course, Wall Street's gone crazy in the last 20 years with derivatives and arcane strategies. So the standard has drifted away from prudent investing to modern portfolio theory.

One issue that that frequently comes up is whether the trust should lend money to a beneficiary. Generally, market-rate loans may be OK—they may even be explicitly authorized by the trust. But what if he wants to borrow at below-market rates? If a trust does not explicitly authorize this, a trustee can protect himself by getting written authorization from the grantor to make the loan.

Even so, a remainder beneficiary could question the trustee about making a loan to a current beneficiary. If it's made at a below-market interest rate, its value is, so to speak, below par.

Duty to Inform and Account

The trustee must keep beneficiaries of the trust reasonably informed of the trust and its administration. This means the trustee must keep accurate accounting records, file all required income tax returns, and report to the beneficiaries at least annually. This is probably the most important of the trustee's duties, because if the trustee fails in it, the beneficiaries have no idea whether he is fulfilling his other duties.

Duty to Take Control of Trust Property

The trustee is obligated to take reasonable steps to secure and keep control of the assets of the trust. This means more than merely taking physical custody of trust property. For real estate, the trustee's duty may extend to getting necessary documents, such as deeds, filed and/or recorded.

Trustee Powers

The key powers of a trustee, depending on the terms of the trust, include buying and selling assets, determining the timing and amounts of distributions to beneficiaries, and hiring and firing advisors, such as investment advisors. Distributions of principal, as opposed to income, are usually at the discretion of the trustee.

Discretion to Make and Withhold Distributions

Some trusts allow the trustee wide discretion regarding distributions. The most common limitation on trustee discretion is HEMS: health, education, maintenance, and support. This may be particularly useful when the trustee is also a beneficiary. This standard is sanctioned in the tax code, so it can prevent the IRS from treating the principal as taxable—and creditors from claiming it. The trustee/beneficiary can use the funds for his dependents, as well as himself, under the HEMS standard.

"Maintenance and support" generally refers to the beneficiary's ongoing lifestyle, which can be documented by a tax return or a budget.

But what if a beneficiary wants to take a distribution to start a business, or buy a home? One way to finesse this problem is to hire an independent trustee. If the independent trustee has power beyond the HEMS standard to make distributions, that can take the trustee/beneficiary off the hook.

The trustee may also want to impose limitations based on beneficiary's condition. Most commonly, he may be authorized to withhold distributions from a beneficiary who has filed for bankruptcy protection or is in the midst of a divorce, under attack from creditors, the defendant in a lawsuit, insolvent, a spendthrift, eligible for government aid, or suffering from drug, alcohol, or gambling addiction.

Further, the grantor might want the trustee to withhold distributions from beneficiaries who are under the control of a spouse or partner, a parent, a religious cult, or an unscrupulous or unreliable financial advisor. The trust may also include a disability clause—authority for the trustee to withhold distributions to a mentally or physically disabled beneficiary. The trustee can also bar a beneficiary from selling or otherwise liquidating his share of the trust.

Because of these considerations, a third-party trustee may be a good idea: he may find it much easier than a family member trustee to say "no" to a beneficiary.

For trusts without independent trustees, the IRS has come to accept that distributions of trust principal for "health, education, maintenance, and support" may be cited to keep the assets from being included in the beneficiary's taxable estate. Because many grantors feel this is too limiting, especially in a trust for the benefit of the surviving spouse, grantors frequently appoint an independent trustee. This enables the trustee to have broader powers to distribute principal without triggering adverse tax consequences.

Other Third-Party Roles

Trust Protector

A trust protector is the person who, in a sense, answers the question: "who will police the police?" He is appointed to oversee the trustee, to make sure that he implements the terms of the trust, and acts in the best interests of the beneficiary(ies).

The trust protector may:

- Review trustee compensation;
- Remove or replace trustees at the beneficiaries' request; and/or
- Make important decisions, such as
    - Amending a trust provision,
    - Creating a new trust with part or all of the trust assets (he can be granted the power to do this), and/or
    - Selling a family business, or other illiquid trust assets.

Having a trust protector has gained favor in recent years. One reason is that he can make decisions that a beneficiary/trustee can't make himself. (One such power can be the power to remove the trustee.) Otherwise, in some cases, the trust property could end up being included in the taxable estate.

If a trust protector is responsible for certain decisions, must he maintain contact with all the beneficiaries, and/or meet with the trustee regularly? If so, will he get paid for his time? The question of whether the trust protector is a fiduciary is difficult—and becoming more and more of an issue.

No corporation will accept the role of trust protector, unless the terms clearly spell out that it is *not* a fiduciary. This also depends partly on state law; some states say trust protectors are not fiduciaries. But in one court case, the trust protector was found to be one—which meant he was on the hook for a bad investment.

Other key issues regarding trust protectors include:

- Should he have a duty to monitor trustee actions to detect bad acts, or only act upon notice from beneficiaries?
- If he acts only in response to beneficiaries, how does he keep informed about the activity in the trust?
- Is he paid for this, and the associated liability?
- Can he expend trust assets to enforce its rules?
- How is he removed and/or replaced?
- Can he amend the trust? (This can be sensitive, particularly for grantors who don't want the terms changed).

Some experts argue that a trust protector is most useful when he has a narrow, specific role: perhaps, reviewing trustee compensation. But he could also be "on call," going into action when something's gone wrong—for example, when the trustee, the beneficiary(ies), and the grantor disagree.

If a trust protector's function is to resolve disputes, what sort of access to trust records and funds should he have? If he needs to get an appraisal of a business held in the trust, can he order it? If so, how does it get paid for? What if the trustee refuses to pay for it?

This is an evolving area of the law, and care must be taken to clearly establish the protector's powers and duties in the trust terms.

Directed Trustee / Administrative Trustee / Co-Trustee

Another third party role is a directed trustee, sometimes called an administrative trustee. His job is to do as directed by another co-trustee or a trust advisor (see below). Directed trustees have no liability if any of these directions turns out to be a bad idea. The trust agreement should absolve directed trustees for this. (Some state laws do, as well.) Directed trusts have become more popular in recent years.

Frequently, this arrangement is used to hire someone to do accounting, tax return preparation, and/or transaction execution, leaving more discretionary functions, such as investment management or distributions, to others. It has become something of a cottage industry recently, especially in New Hampshire, Florida, and Delaware. Many investment managers prefer working with directed trustees; their trust companies will accept as clients only trusts that provide for directed trustees.

Some trust companies, particularly in Delaware, do only tax returns, accounting, and back-office functions. Everything else is delegated either to a co-trustee, investment trustee, or investment advisor.

Some experts say it's good to use co-trustees who have limited responsibilities. Suppose one asset in the trust is a vacation home in a different state from everything else. It may be appropriate to have a co-trustee just for that asset.

By contrast, a trustee who delegates the investment function is responsible for investigating the investment manager he chooses. Consider Bernie Madoff. How many trustees were sued, because they never checked up on him? Otherwise, he might have been caught much sooner. Apparently, they failed to discharge their duty of supervision.

Trust Advisor

The function of the trust advisor, another third party role, is to direct the trustee within a specific realm. Trust advisors usually work with directed trustees.

Most often, a trust investment advisor sets investment policy and makes allocation and buy/sell decision. Then he directs a directed or administrative trustee to execute those policies.

In other cases, trust advisors may be responsible for making distributions to beneficiaries, or managing a closely-held business or family real estate.

Jurisdiction and Key Concepts

Jurisdiction

The location of the trust "home," so to speak, can be quite important for tax purposes. Some trusts may authorize the trustee to relocate the trust if doing so will reduce the tax burden. However, this may require the approval of the beneficiaries and/or a court.

It is clear that the home state of the grantor need not be the state whose laws apply to the trust. In some states, whether a trust is taxable depends on where the grantor signed it. Others say it depends on the location of the beneficiaries, the trustee, and the grantor. Still others make it depend only on the location of the trustee. Further complicating the issue is that trust documents often identify the state whose laws apply. If a trust is designated a Texas trust, Texas law applies even if a beneficiary in California files suit against it.

In recent years, trust documents are being drafted so that the trustee can change the jurisdiction—or select a jurisdiction other than where he lives. If the trust is silent on this issue, unanticipated issues can arise.

Modifying the terms of "Irrevocable" Trusts

In theory, the terms of an irrevocable trust generally cannot be changed, even during the grantor's lifetime. **Grantor Retained Interest Trusts** (see page 20) and **Intentionally Defective Grantor Trusts** (see page 22) are exceptions.

But, despite all the boilerplate and other terms, parties to a trust have so many opportunities to alter, amend, change, revoke, and/or "decant" an "irrevocable" trust that nothing is etched in stone any more.

Decanting

This expression, drawn from the world of wine, means "pouring" the assets from an old trust into a new one, with updated terms. Many UTC states authorize this; the beneficiaries and standards must be maintained, though.

For instance, trustees can't eliminate a beneficiary's vested interest. But decanting could make it possible for the trustee to, for example, raise the age of a beneficiary's first distribution, or move the trust to a state that offers greater flexibility regarding taxes or administrative roles. If the trustee wants to retire, decanting also can make it easier to name a new trustee.

Cy-Pres

When the purpose of a charitable trust can no longer be effected, the trustee needs direction on how to administer the assets. Cy-Pres (French for "so close") guides the court in finding a closely related objective. The Cy-Pres concept permits the modification of grantor's intent to align with legal requirements and updated social mores.

For example, a 1945 Alabama trust provided funds to maintain a local public park, as long as it remained racially segregated. After the civil rights movement, that directive could no longer be implemented. Another purpose had to be found.

Rule against Perpetuities

In English common law, perpetual trusts were not permitted; trusts had to have termination dates. However, many states have abolished the rule against perpetuities in the last 10-15 years. This enabled the creation of dynasty trusts (see page 22).

Other states have established a maximum number of years. This can be problematic for generation-skipping trusts.

Nevertheless, the rule against perpetuities still applies in most countries whose legal systems have Anglo-Saxon roots, including many offshore jurisdictions. Others limit trusts to 1,000 years.

If a trust is subject to the rule against perpetuities, it will be considered void 21 years after the death of the last "life in being" (usually, the last surviving beneficiary who was alive when the trust was created). The reason for the rule is to prevent tying up assets too long.

Incapacity Clause, Minors

Most trusts grant trustees flexibility in withholding required distributions for unforeseen circumstances involving minors and any other beneficiary(ies) who are unable to receive them, or should not, at least for the time being. The UTC allows a parent, or somebody similarly situated (such as an 18-year-old beneficiary with a 12-year-old sibling) to be legally bound to such beneficiaries. Even when the trust terms instruct the trustee to distribute assets or income to a beneficiary, drug addiction, medical issues, mental issues, influence of a cult, incarceration, or a vow of poverty may enable the trustee to hold on to the money.

Trustees can use an incapacity clause to cancel otherwise mandatory distributions until the incapacity is removed (if ever). The assets remain in trust for the future benefit of the incapacitated beneficiary.

"Spendthrift" Clause

A spendthrift clause helps prevent an irresponsible beneficiary from losing his share of a trust in a bankruptcy, or, more generally, to creditors. It prevents him from selling his prospective benefits from the trust to get current cash.

Support Obligations Clause

A support obligations clause manages the intersection of certain domestic relations laws, tax law, and trust laws, to make sure a beneficiary doesn't run afoul of any of them.

The Most Common Types of Trusts

Although all trusts are either revocable or irrevocable, there are many different specific types of trust. Most are irrevocable, because that is the only way that the grantor can accomplish his purposes.

A/B or Marital/Credit Shelter Trusts

For many years, this has been the most common type of tax planning trust. Usually, it splits the assets into shares at the death of the grantor. If any of the grantor's estate/gift tax exemption remains unused when he dies, that amount goes to the "B"/credit shelter trust (so called because the assets are sheltered from the estate of the grantor). The "A"/marital trust receives the rest of the assets. The surviving spouse must receive all the income from the "A" trust to qualify it for the unlimited marital exemption.

Usually, the assets go to the second-tier beneficiary(ies) after the death or remarriage of the surviving spouse. A difficulty with this arrangement can arise, of course, when the surviving spouse is not the biological parent of the second-tier beneficiary children.

The purpose of such a trust is to forestall federal estate tax liability when the first spouse (grantor) dies. Upon the death of the surviving spouse (assuming no remarriage), the "A" Trust assets are subject to estate tax. Meanwhile, the "B" trust assets grow tax-free until the children (or, in the case of a generation-skipping trust, grandchildren) die.

Qualified Terminable Interest Property (QTIP) Trusts

The purpose of a QTIP trust is to convey assets tax-free from one spouse to another, without allowing the surviving spouse's *next* spouse to get them. Many newly established QTIP trusts require that the grantor's spouse shall be treated without regard to any other beneficiary(ies)--shall be favored, in other words.

A QTIP trust ordinarily comes into effect at the death of the first spouse, with the splitting of the trust into A/B shares, as noted above. But if the widow(er) remarries—or if she doesn't, when she dies--the trust terminates.

A terminable interest means the surviving spouse will receive a life estate—usually net income, plus access to principal for education, maintenance, and support—but does not have the absolute right to withdraw everything.

As with the A/B trust, at the second spouse's death, the assets will be included in the estate, and estate tax liability may result. So taxes may be deferred, but not avoided forever.

For the trust to receive the unlimited marital exemption, rules govern how much control the surviving spouse must have. QTIPs are designed to follow those rules (that is, they are "qualified") without giving the funds outright to the surviving spouse. Mostly, this means that nobody else can receive the assets (at first), and that the election to be treated as a QTIP has been made on the correct forms. If the spouse gets an interest that is not properly qualified, the marital exemption is not allowed.

Qualified Domestic Trusts (QDOTs)

Neither the unlimited marital exemption nor unlimited lifetime gifts apply to non-US citizen spouses. (The current limit on gifts to non-US citizen spouses is $145,000 annually.) So, QDOT trusts can be useful for couples when only one is a US citizen. The terms of a QDOT should provide that all income is distributable to the surviving non-citizen spouse. Every distribution of principal from the QDOT to the surviving spouse is subject to estate tax, which is computed as if the distributions were included and taxed in the first spouse's estate. Otherwise, though, such trusts delay estate tax liability until the death of the surviving spouse. The estate tax ultimately levied is on the value of the assets at the time of surviving spouse's death, so the growth is also taxed.

QDOT trusts have very strict requirements, because the IRS is concerned that a non-citizen spouse may abscond with the assets, thus escaping estate taxes. They must have US trustees.

If the QDOT assets exceed $2 million, then one trustee must be a U.S. bank. If there is an individual trustee, he must post a bond or letter of credit to the IRS in the amount of 65 percent of the value of the trust assets to secure payment of the tax. If the trust assets are less than $2 million, no bond need be posted, and a U.S. bank need not be a trustee, provided that no more than 35 percent of the trust assets consists of real estate outside the U.S.

Irrevocable Life Insurance Trusts (ILITs)

The usual purpose of an ILIT is to keep the policy value and proceeds out of insured's federal taxable estate. The trust owns the insurance policy; upon the insured's death, it receives the proceeds, and either holds or distributes them, according to its terms.

Second-to-die policies are popular in ILITs. They must meet specific tax rules—for one thing, there must be no benefit to the grantor during his lifetime, to keep the proceeds out of the taxable estate.

Most ILITs sit idle until the insurance pays out; the only activity is the payment of the premium and the Crummey notices (see page 22). When the insurance pays out, the trust might dissolve, cutting the bank out of any more fees. That's why banks don't like to be trustees of ILITs, and tend to charge high fees to discourage them.

Generation-Skipping Transfers and Trusts

If a grandparent leaves assets directly for a grandchild, effectively skipping the generation in between, less estate taxes might be paid than if they were levied on each generation.

That's why Congress created the generation-skipping transfer tax (GSTT). The tax rate (above the $5.3 million exemption) is 40%, the same as the estate tax rate. Some gifts could be subject to both estate tax and the GST tax. (Some also may be deemed to violate the rule against perpetuity.)

To forestall GST tax, GST trusts were created. They benefit the child(ren) of the grantor during his lifetime, by providing them the net income plus, perhaps, access to principal at a designated percentage per year. But because the assets are only accessible--not directly withdrawable--by the child, he is considered "skipped:" exempt from estate taxes on the assets.

After the trust assets ultimately are distributed to the beneficiaries (usually the grandchildren), they may be subject to the federal estate tax on the beneficiary's estate.

If some of the assets are exempt from GST, they are not subject to GST tax, though they may be subject to estate tax. Some GST trusts include non-exempt and exempt portions. It is crucial to distinguish between them, even though frequently they are governed by a single trust agreement. When possible, it's best to distribute non-exempt funds first.

Skipping a Generation; Skip Persons

If the beneficiary is a descendant of the grantor, then being more than one generation below the donor means that the recipient is what is called a skip person (grandchild or great-grandchild). The exception is if the grantor outlives the middle generation(s).

If the beneficiary is not a descendant of the grantor, he is deemed a skip person if he is more than 37.5 years younger than the grantor.

The following events in GST trusts generate tax liability:

- Taxable distributions: A distribution of non-exempt assets from a trust to a skip person
- Taxable termination: When the trust is terminated, and non-exempt funds are distributed to skip person(s)

- Direct skips: Giving funds in excess of the exemption directly to a skip person(s).

In many cases, the biggest hurdle to moving or modifying older trusts can be the GST rules. Generally, anything other than "administrative" change can trigger tax, or loss of grandfather status.

Right now, gift, estate, and GST taxes are somewhat aligned. But for many years, they were either out of sync with each other regarding the lifetime exemption, untethered from each other artificially, or outdated, and the exemptions were very low. As a result, many trusts have multiple parts to them.

For instance, a Reverse QTIP Trust took into account that, at one time, the estate tax exemption was only $600,000, but the GST exemption was $1 million. Also, "Gallo" trusts (so named after the winemaking Gallo family of California) were authorized during a very short time in the late 80's. They took advantage of the GST exemption of $2 million per grandchild, rather than the then-usual $1 million. But this special exemption expired after 1989.

"Crummey" Trusts

The purpose of a Crummey trust is to make current gifts to beneficiaries without giving them access to *all* the assets.

Many estate plans call for annual gifts to heirs, often through trusts. To be eligible for the annual gift tax exclusion, these contributions must be of a "present interest," which means that the beneficiary must be able to access the assets immediately, without restriction. The problem is that in many cases, contributions to trusts are of a "future interest," because the beneficiary's access is restricted until some future date or event.

The Crummey power is an oft-used trust provision that allows a contribution that would otherwise be a future interest to be treated as a present interest, and thus, qualify for the annual gift tax exclusion. It is named after Dr. Clifford Crummey, who won a landmark tax case in 1968. It established that the contributions being made to the trust are considered **present** and **completed** gifts---both of which are required under tax law.

Crummey powers give the beneficiary a limited time (often 30-60 days) to withdraw new contributions, converting the future interest contribution to a present interest. Beneficiaries must receive notice of their right to withdraw. The most basic step, sometimes forgotten by careless trustees and advisors, is providing notice to beneficiaries of the withdrawal power when a contribution is made to the trust. This requirement is often spelled out in the trust document, generally stating that beneficiaries must receive detailed and timely written instructions on how to exercise their withdrawal rights.

Such a Crummey notice need not be legal document drafted by an attorney. Instead, it can be a letter from dad or grandpa. The same letter can be reused, every year.

If a beneficiary does not exercise his right to withdraw within the specified time, the Crummey power is deemed to have lapsed, and the assets remain in the trust.

This withdrawal right is generally limited to an amount equal to the current annual gift tax exclusion—$14,000 per year, per recipient. Otherwise, the Crummey formula allows the grantor to maximize current gifts without triggering tax liability. The beneficiary can withdraw the greater of $5,000 or 5% of the principal balance annually. This limitation is intended to shelter trust property from creditor claims or gift/estate tax exposure.

If the beneficiary fails to make the timely withdrawal, the value of the property greater than $5,000 or 5% of the trust principal is considered to be a gift by the beneficiary, subject to his own gift tax liability. To forestall this, trusts should be drafted to account for it. One way is to draft a cumulative withdrawal power, so that the excess continues to future years.

The IRS continues to attack Crummey trusts in court, though it has lost every such case. Accordingly, trustees, advisors and beneficiaries must follow Crummey rules closely to protect themselves.

Crummey clauses are also frequently seen in ILITs and other irrevocable trusts, in which the grantor deposits funds into the trust for the benefit of others during the grantor's lifetime.

Section 2503(c) (Minor's or Grandchild's) Trusts

These irrevocable trusts are somewhat analogous to Crummey trusts, except that the recipients are minors. Contributions on behalf of minors are considered present and complete, even if the beneficiary doesn't directly receive the money. The property and income in the trust may be expended by or for the benefit of the child before the child reaches age 21, accumulate in the trust, or be distributed to the child. The trustee has the authority to make distributions on behalf of the child or directly to the child until he reaches age 21.

All undistributed property and income in such a trust must be distributed to the child on his 21st birthday—which may displease some trustors. If the child dies before reaching age 21, the trust assets will be included in the child's estate.

Charitable Trusts

A **charitable trust** must be formed for the benefit of a qualified charitable organization. Most generate a current income tax deduction for the charitable contribution, while deferring the ultimate gift, perhaps spreading it over a number of years. In a **charitable remainder** (split-interest) **trust**, the charity is the remainder beneficiary, while an individual or individuals are the current beneficiaries. It pays earnings on the principal to whoever the grantor designates. They can be ideal for converting low-basis assets into current income and charitable gifts. The terms say the charity gets the capital either after a certain number of years, the death of the grantor or beneficiary, or some other event.

Under a **charitable Unitrust**, the current beneficiary is entitled to an annual percentage of trust assets. In a **charitable trust annuity**, the current beneficiary is entitled to a fixed amount annually. Many of these trusts permit the grantor or his family to change and/or appoint new charities to receive the charitable portion.

To qualify for a charitable deduction, the law stipulates very specific terms, so these trusts typically have very exact, detailed language and many boilerplate provisions.

A **donor-advised fund** is similar to a charitable trust; the donor receives an up-front income tax deduction for contributions. It can have a much lower administrative costs than a private foundation. The donor (and his family) retain the right to recommend charitable gifts to be made by the donor-advised fund.

Grantor Retained Interest Trusts, Annuity Trusts, Unitrusts

In general, if the grantor retains any type of control of, or receives any benefit from, a trust, even if irrevocable, the trust remains in his federally taxable estate. This has given rise to grantor retained interest trusts.

In a **grantor retained interest income trust**, the grantor receives the net income from the trust. In a grantor annuity trust, he receives a fixed amount annually. In a unitrust, he receives a fixed percentage annually.

The purpose is to freeze the value of assets for estate tax purposes, and preserve the estate tax exemption, while allowing the grantor to benefit from the earnings on the asset (or other use of it). If the grantor dies before end of the designated term of the GRT, the assets go back into the Grantor's estate. "Rolling" GRTs came about as a way to forestall this.

GRTs became very popular in recent decades, partly because of a favorable interest-rate environment. However, since there are limits on how long they can run, and many are now ending, or have ended, some grantors are unhappy to see the assets go to the ultimate beneficiary.

Very complex and specific tax rules are in force to prevent perceived abuses as to term and the amount of retained benefit. GRTs are barred from borrowing from the grantor to meet their annual payment obligations.

Qualified Personal Residence Trusts

This type of irrevocable trust typically holds a primary or secondary residence (which can include a vacation home), allowing the grantor use or benefit of the property. It can be an estate "freeze" technique: a gift of the property is made when the trust is created, and any subsequent growth in its value goes to beneficiary, estate tax-free.

Like GRTs, QPRTs have been an attractive tax planning entity recently. (Also like GRTs, the grantor must survive the term of the trust for them to be effective.) The grantor must pay fair market rent; the trust specifies who pays utilities, property taxes, improvements, and insurance. Formalities must be followed. If they aren't—as often happens--the IRS loves to pull the assets of QPRTs back into estates.

At the end of the term of the trust, the residence is distributed to the ultimate beneficiary(ies). It's crucial that all parties understand the beginning, middle, and end phases of the trust, not just the tax benefit. Many grantors are very sentimental about their residences; they resist giving them to children, and paying rent.

Domestic Asset Protection Trusts / Creditor Protection Trusts

This type of trust is formed for the same reason as offshore trusts: keeping assets away from *future* creditors—not current creditors, a spouse, nor support obligations to children. After someone has declared bankruptcy, or been sued for divorce, it's too late to form this kind of trust. Nor will they help reduce or defer taxes.

They are still relatively new in the US and, as such, no case law has developed as to whether they are enforceable, if challenged by creditors.

Special Needs Trusts

These are created to benefit beneficiaries with special needs, without providing the money directly to the beneficiary, to forestall undercutting the beneficiary's rights to as many federal and state benefits as possible. They work in conjunction with state and federal programs such as SSI and Medicaid, which typically have stringent income and asset limitations. States work very hard to recoup funds from both current recipients of aid and their estates, and to keep as few people as possible receiving the aid. Therefore, the trust documents must be worded very carefully. State laws vary considerably, so it is very important that whoever drafts the trust specializes in this area of law and the state in question.

Intentionally Defective Grantor Trusts

This type of trust takes advantage in the differences in the estate tax and income tax rules defining the word "grantor." The trust makes the grantor the owner for income tax purposes, but not for estate tax purposes. The "defect" is that the grantor is still liable for income taxes on the earnings of the assets in the trust. Even so, his having contributed the assets to the trust reduces the eventual estate tax liability.

The trustee might "sell" the assets to the trust in exchange for a promissory note of 10-15 years. The note will bear an interest rate high enough to be regarded as above-market, even though the foregone assets are expected to appreciate faster.

Dynasty Trusts

The reason for establishing dynasty trust is not to reduce taxes, but to create a "dynasty"—that is, to provide for multiple generations in a family. This differs from most other types of trust, which are designed to pay out most of their assets at designated times. In dynasty trusts, the trustee(s) is encouraged to keep the assets inside the trust—and away from such third parties as ex-spouses, trade creditors, and the IRS.

Of course, a powerful benefit of such long-running trusts is that they allow growth in the assets tax-free, except to the extent that they distribute earnings or principal. Over time, they can grow to many times the value of the grantor's contributions, without anyone paying taxes on that growth.

Dynasty trusts are closely related to the Rule Against Perpetuities (see page 14). If the trust is exempt from the RAP, theoretically, it can continue forever. This, however, does not necessarily mean the assets won't ultimately be subject to estate tax or GSTT.

Overlapping types of trusts

A single trust can fall into multiple categories. For example, an ILIT could have Crummey provisions, a marital trust could also be a QTIP, a Credit Shelter Trust could also be GST, and a 2503(c) could also be an IDGT.

Setting up the Trust

The Trust Agreement

A trust agreement is what governs the relationship between the grantor and trustee. A trust document is usually signed in triplicate: a copy for the grantor, one for the trustee, one for the attorney who drafts it.

The name of the trust should include its effective date, because families frequently have multiple trusts. But family trust names should avoid numbering ("Smith Family Trust #1"), because that can trigger IRS curiosity.

Revocable trusts are usually named for the grantor, but irrevocable trusts are often named for the family. A trust document can be called an instrument or a declaration as well. The word "declaration" usually appears in the context of a revocable trust.

The grantor, trustee, and effective date, as well as the name of the trust, should appear at the beginning of the trust agreement. A table of contents can be helpful.

Next come the dispositive provisions: which beneficiaries will get what, when, and how. The beneficiary(ies) may be the grantor (in the case of revocable trusts; this usually includes the grantor's spouse); individuals ("my granddaughter Britney-Mikayla"); or a class of persons ("my descendants.")

The benefits may be described as

- specific amounts ("$50,000 to each of my nephews");
- income only;

- principal only;
- income and principal, subject to the trustees' discretion;
- income and/or principal for "health, education, maintenance and support;"
- graduated principal payouts (33% at age 30, 50% at age 40, balance at age 50); or
- annual annuity or "unitrust" payments (in a family trust---"4% of the January 1 balance each year to my child, payable in quarterly installments.")

In a charitable lead annuity trust, the terms might grant $500,000 to Charity X annually. In a grantor retained annuity trust, it might be X% of the original trust balance to the grantor annually.

The trust document might also designate withdrawal powers, such as annual gift or Crummey powers (see page 21).

Executing a Trust

Each state has its own rules on the requirements for executing a trust. These rules may govern whether it must be notarized, the number of witnesses necessary, and whether it needs to be self-proved. **Self-proving** means that the grantor and witnesses were sane, capable, and present at the signing of the document.

Most state laws provide that if a trust agreement was executed properly in the state where the grantor was located at the time of execution, it will be accepted in the grantor's current resident state. In general, trusts follow the grantor.

Although this is generally a big advantage, it also means that trust terms must have both direction and flexibility built in, for different places and different times. This is why "dead hand control," although it may please grantors in the short term, can work out very badly in the long term.

Accounting

Every state specifies which parties to a trust are entitled to receive an accounting, and what that means. Generally, a trustee needs to make sure that the financial statements he provides to beneficiaries meet the terms of the statute, which vary from state to state.

But even UTC trustees must keep beneficiaries informed about such matters as earnings, contributions, distributions, capital gains and losses, and beginning and ending balances. This is to make sure that a reasonable person can understand the important events that occurred during an accounting period. When a beneficiary receives that information, he is deemed to be aware of the important events. Larger trust companies have designed their statements to meet those requirements, generally.

Most grantors want to hold their cards as close as possible to their chest. While the grantor is still alive, the terms of the trust can bar sending accounting statements to the beneficiaries. The statutes of at least one state, New Hampshire, specifically authorize this. Alaska, South Dakota, Delaware, New Hampshire, and Florida have also lenient notice rules. (This has prompted some grantors to "shop" for a state in which to establish their trusts.)

On the grantor's death, however, beneficiaries must begin to receive financial statements, although the exact requirements vary by state. Whether contingent and vested trustees are entitled to receive financial statements depends on the state.

If a beneficiary waives her right to an accounting, is that good enough? The short answer is no; there's not enough precedent to defend that position.

Proper Notification

Generally, sending the financial statements to the beneficiaries by electronic mail does *not* fulfill notification requirements. Surface mail is better. (Certified mail and registered mail are options.) The law says that, once the trustee has put the statements in the mailbox, he has fulfilled his responsibilities. It's also a good idea for the trustee to ask the beneficiar(ies) and/or the trustor for a written acknowledgement of receipt. The next best thing is a waiver.

Conclusion

A closing word from the author, summarizing what he hopes the reader takes away, where to go for more information and a reminder that the law is evolving so check to make sure your knowledge is current before acting. This section needs to be written.