Estate Planning Insights

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LET'S DISCUSS TRUSTS-PART ONE

People Say They Don't "Like" Trusts. Over the 36 years of my trusts and estates practice, many clients have told me they don't "like" trusts. That is sort of like telling a chef you don't like vegetables! There are many different types of trusts that provide many different types of benefits and it seems nonsensical to lump all trusts together and treat them like Brussels sprouts. Perhaps what those clients were really trying to say is that they don't "understand" trusts.

In this newsletter and our next newsletter, we are going to provide a simple explanation of trusts and the benefits trusts can provide. We are not trying to write a legal treatise on trusts. We just want to provide some basic information about trusts. We will get more complicated as we go along, though!

What Is a Trust? In its most basic form, a trust is a legal arrangement in which the ownership of the assets is split between the "legal owner" and the "beneficial owner."

The trustee is the *legal owner* of the trust assets. That means the trustee has legal title to the trust assets. Technically, the title to every trust asset should reflect not only the name of the trust but also the name of the trustee (it's surprising how many people do not know this and think that the name of the trust is sufficient legal title). The trustee usually has the power to buy, sell and exchange the trust assets. Normally, the trustee should invest the trust assets in way that is both safe and productive (i.e., produces income and/or grows in value). That is part of the trustee's duty to manage and administer the trust. The trustee usually also has the power to make distributions out of the trust to or for the benefit of the beneficiary. Those distribution decisions are based on the terms of the trust and the trustee's judgment. Everything the trustee does, however, should be done for the benefit of the "beneficial owner" of the trust.

The *beneficiary* is the "beneficial owner" of the trust. Another term that can be used to describe the beneficiary is the "equitable owner" of the trust. The trust was created for the benefit of the beneficiary. In a way, then, the beneficiary of the trust is the "true owner" of the trust, although the beneficiary is not the "manager" of the trust. The trustee is the manager of the trust for the benefit of the beneficiary.

The trustee is a "fiduciary" and, therefore, the trustee owes a "fiduciary duty" to the beneficiary of the trust. The trustee must act loyally and for the benefit of the beneficiary (and not in his own self-interest). The trustee must exercise the highest level of care when it comes to the trust assets and his management of the trust. Serving as a trustee is a very hard job.

Trusts can last for the entire lifetime of the beneficiary or merely for a specified period of time, such as until the beneficiary reaches a certain age. Trusts for young people are common. As we have discussed, significant assets should not be given or left directly to a minor–i.e., a person under age 18. In general, there are three ways to give amounts to a minor: (i) to a custodial account, (ii) to a 529 plan (which we will not discuss in this newsletter) or (iii) to a trust. If the total amount that is going to be given to the minor is relatively small (e.g., under $50,000), it can be distributed to a "custodian" for the minor under the Texas Uniform Transfers to Minors Act (TUTMA). The custodian will manage the assets until the child reaches age 21, at which time the custodial arrangement will terminate and the 21 year old will take control of the assets. Many people feel that age 21 is too young to turn over a large amount, however. Therefore, people usually give larger amounts to a trust for a young beneficiary.

All trusts have at least 2 beneficiaries: a current beneficiary and a "future" beneficiary. The current beneficiary is the person to whom distributions from the trust can be made at the current time. Depending on the terms of the trust, when the trust for the current beneficiary terminates, either the trust assets will be distributed outright and free of trust to the current beneficiary or the trust assets will be distributed to "someone else." That *someone else* who receives what is left in the trust when it terminates is called the "remainder beneficiary" of the trust. Even if the trust is one that terminates when the beneficiary reaches a specified age, it is possible for the beneficiary to die prior to that age, so, again, someone else must be named as the *remainder beneficiary* of that trust.

A trust can have more than one trustee at a particular time (co-trustees). Co-trustees usually must act jointly. All trusts should name at least one successor trustee to act if the primary trustee ceases to serve.

A trust can have more than one current beneficiary and more than one remainder beneficiary. In the case of certain types of trusts, the beneficiary can serve as the trustee of the trust. Even in that case, that person is really two different people, legally. That person is the *trustee* when he is managing and administering the trust and that person is the *beneficiary* when he is receiving benefits from the trust.

Another way to look at trusts is as an arrangement with three parts: a trustee, a beneficiary and at least one trust asset. The trust asset was initially referred to as the "res" (the Latin word for "thing") or as the "corpus" (the Latin word for "body"). More modern terminology refers to the assets of the trust as the "principal" of the trust. For various reasons, we frequently need to distinguish between the principal of the trust (the assets themselves that are owned by the trust) and the income of the trust (the income that is earned by those trust assets).

A trust can be a separate taxpayer for federal income tax purposes depending on how it is structured. We will discuss various tax matters relating to trusts later in this newsletter and in our next newsletter.

Trusts can be "revocable" or "irrevocable." That is just like it sounds. A *revocable* trust can be revoked. A revocable trust can also be amended or modified. Technically, an *irrevocable* trust cannot be revoked or amended or modified.

Because an irrevocable trust is *irrevocable*, it is very important to include as much flexibility as possible in irrevocable trust instruments. Of course, not all future developments can be anticipated. That is why trust creators sometimes appoint certain people to exercise certain powers in the future to make changes, as necessary or desirable. That is also why trust beneficiaries are often given testamentary "powers of appointment" over a trust. Powers of appointment *can* allow the current beneficiary of the trust to change the remainder beneficiaries of the trust (i.e., the persons who will receive the trust assets when the trust terminates) or to change their shares or to change the form of distribution (in trust or outright).

Sometimes, a "serious problem" develops with an irrevocable trust. In that case, if applicable state law allows, all persons with an interest in that irrevocable trust can file a petition with a court having appropriate jurisdiction, asking the court to terminate or modify the trust. If the court agrees that the trust should be modified or terminated, it can sign a judgment to do that. In addition, sometimes all persons with an interest in an irrevocable trust can sign a "Family Settlement Agreement" terminating or modifying the trust. There can be adverse tax consequences in cases where an *irrevocable* trust is terminated or modified, however (whether via court action or private action), so all potential tax effects should be carefully evaluated before that type of action is taken.

Although there are such things as oral trusts, 99.99% of trusts are created through a "written instrument" of some sort. A trust can be created by (i) a written trust agreement, (ii) a written trust declaration or (iii) a Will. When a trust is created pursuant to a written trust agreement or a written trust declaration, the *creator* of the trust is called the "settlor" or the "trustor" or the "grantor." *Revocable trusts* are often created via a trust declaration rather than a trust agreement. The difference between a trust *agreement* and a trust *declaration* is that, with a trust agreement, the settlor(s) and the trustee(s) are not identical. In other words, at least two different persons (i.e., one person as trust settlor and a different person as trustee) are executing the trust agreement (contract) in which they are agreeing to create a trust. With a trust *declaration*, the same person is both the settlor and the (initial) trustee of the trust. In that case, the settlor is "declaring" that he has placed assets into a trust.

A trust created in a Will is called a "testamentary trust" because "testament" is the French word for a Will. It is surprising how many people do not understand that a trust can be created in a Will. In the case of a *testamentary* trust, there is no separate trust agreement or trust declaration–the Will itself is the "written instrument" that establishes the trust. Of course, the Will must be "admitted to probate" before it has any legal validity and the testamentary trust becomes effective

Before we get into the various tax aspects of trusts, as well as the various benefits of trusts, let's consider *why* so many trusts have been created over the last 36 years.

When Trusts Became "Standard" In Estate Planning. Thirty-six years ago, when I first started practicing trusts and estates law, I really did not understand trusts very well, even though I had taken a "wills and trusts" course in law school. Back then, except for trusts created for minor children, trusts seemed "very exotic" and something that only "rich people" created. Then Congress passed the "Economic Recovery Tax Act of 1981" ("ERTA") and the big law firm where I worked decided that every single client's estate plan needed to be updated. Estate planning files were stacked in tall piles along the walls in all of the estate planning associates' offices and the process of updating estate plans began in earnest.

One change made by ERTA was to permit an "unlimited" marital deduction for the first time. ERTA also provided for increases in the estate tax exemption amount over time, from $175,000 in 1981 to $600,000 in 1987. Further, ERTA reduced the maximum estate tax rate over that same time period from 70% to 55%.

The *unlimited* marital deduction was a very welcome change in the law. The marital deduction allowed estate taxes to be deferred until the death of the surviving spouse. Thus, it preserved a couple's assets for use by the surviving spouse. However, it still did not make sense in many cases to leave 100% of the assets owned by the first spouse to die (the "deceased spouse") directly (outright) to the surviving spouse. That is because an outright gift to the surviving spouse of all of the deceased spouse's assets resulted in "stacking" 100% of the couple's assets in the surviving spouse's estate.

Back in 1981 (and still true today) married couples did not "automatically" get 2 exemptions from the federal estate tax. Without doing "estate planning," married couples only got 1 exemption per couple, which was applied on the death of the surviving spouse. Thus, if the total value of the surviving spouse's estate at the time of her death exceeded 1 estate tax exemption amount, estate taxes had to be paid on the excess at rates ranging from 18% to 70% (the top rate varied by year). In essence, couples who did not affirmatively utilize the estate tax exemption amount of the deceased spouse were *wasting* that spouse's exemption amount and paying "unnecessary" estate taxes (i.e., estate taxes on the deceased spouse's exemption amount) when the surviving spouse died. Therefore, in the case of married couples *with estates larger than 1 exemption amount* (not 2), the typical estate plan was to place assets belonging to the deceased spouse equal to his exemption amount into a "Bypass Trust"(also called a "Credit Shelter Trust") for the benefit of the surviving spouse and to distribute any excess owned by the deceased spouse either outright to the surviving spouse or to a Marital Trust for the surviving spouse. In that way, married couples (i) avoided paying estate taxes when the first spouse died and (ii) avoided *wasting* the deceased spouse's estate tax exemption amount. The result was a reduction in estate taxes payable on the death of the surviving spouse.

The Bypass Trust provided other benefits, too, such as "remarriage protection" and creditor protection. In addition, if children and grandchildren were permissible beneficiaries of the Bypass Trust, more income tax options were available to the family each year. (We will discuss these other aspects of the Bypass Trust and of other irrevocable trusts in the second newsletter in this series.)

In our recent newsletters, we have discussed the America Taxpayer Relief Act of 2012 (ATRA), which was passed in January 2013. ATRA made 2 significant changes to the estate tax laws. First, it set the estate tax exemption amount at $5 million, indexed for inflation. The 2017 exemption amount is $5,490,000 (we will refer to the exemption as $5 million for simplicity). The higher exemption amount

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is sufficient to cover the combined estate of many couples. Therefore, many couples no longer *need* 2 exemptions in order to avoid estate taxes. Second, ATRA made permanent an alternative method for married couples to obtain 2 exemptions from the estate tax: the portability election. If couples do not want to establish and fund a Bypass Trust on the deceased spouse's death, but they want 2 exemptions from the estate tax (and not just 1), the executor of the deceased spouse's estate can file a Form 706, US Estate Tax Return, within 9 months of the deceased spouse's death and make the portability election. As a result of the portability election, the deceased spouse's *unused* estate tax exemption amount (the "DSUE Amount") is transported to the surviving spouse. If all of the deceased spouse's assets pass outright to the surviving spouse and the surviving spouse is a US citizen, the unlimited marital deduction will apply to that transfer, which means that *none* of the deceased spouse's $5 million exemption amount is being used on that transfer. Thus, if the portability election is made, the surviving spouse will have $10 million of estate tax exemption (the deceased spouse's unused $5 million exemption and her own $5 million exemption) to shelter transfers she makes upon her death from the estate tax. Of course, there are some "drawbacks" and "risks" to the portability election, which we have discussed in our recent newsletters.

We will continue discussing trusts, including the pros and cons of trusts, in our next newsletter.

Estate Planning Check Up. If your estate planning documents were created before January 2013 and you have not come in for an estate planning check up recently, please call our office to schedule a check up soon!

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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