Estate Planning Insights

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Descendant's Trusts For Children and Grandchildren

Introduction. In this newsletter, we will discuss the use of "lifetime, protective trusts" for children, grandchildren and other beneficiaries. Most attorneys in Houston call these trusts, "Descendant's Trusts," but different names can be used for this type of trust. For example, sometimes a *lifetime, protective trust* for a child is called a "Child's Trust," while a *lifetime, protective trust* for a grandchild is called a "Grandchild's Trust." We will use the term "Descendant's Trust" to mean an irrevocable, non-grantor trust created by a parent, grandparent or other "third party" for the lifetime benefit of a child, grandchild or other beneficiary. Descendant's Trusts can be created to become effective on the death of the (second) parent (or grandparent) or can be created to become effective while the trust creator (the "Trustor") is still living.

When inherited (or gifted) assets are placed in a Descendant's Trust, valuable benefits are obtained. We will summarize those benefits in a very simple manner, based on Texas law.

1. The assets held in the Descendant's Trust are protected from loss due to a divorce.

2. The assets held in the Descendant's Trust are protected from loss due to any other kind of lawsuit (e.g., personal injury, professional malpractice).

3. To the extent the Descendant's Trust is drafted to allow distributions to be made to persons other than the primary beneficiary, such as children and grandchildren of the primary beneficiary, there will be more income tax options each year and potential income tax savings. That is because trust income can be distributed to any one or more of those trust beneficiaries, some of whom might be in very low income tax brackets (income distributed out of the trust to a permissible beneficiary results in that income being taxed to that beneficiary–not the trust itself–in that beneficiary's own income tax bracket). In addition, distributions from trusts are not subject to the gift tax rules (trusts don't make "gifts"–they make distributions), so there are no gift tax consequences of the trust making distributions to beneficiaries in amounts larger than the annual gift tax exclusion amount.

4. In many cases, when the primary beneficiary of a Descendant's Trust dies, the assets held in the trust at that time are not includable in the beneficiary's estate and, therefore, no federal estate taxes are payable on those trust assets when they are distributed to the beneficiary's children–or to new Descendant's Trusts for the beneficiary's children. On the other hand, sometimes it is desirable to include the trust assets in the beneficiary's estate at death. That result can be achieved by including certain trust provisions. Most Trustors desire to avoid application of the Generation-Skipping Transfer Tax ("GST Tax") when the trust beneficiary dies. There are ways to produce that result (discussion of that is beyond the scope of this newsletter).

Another potential benefit of Descendant's Trusts is the ability to provide for professional management of the trust assets by appointing a professional Trustee or Co-Trustee and/or an investment advisor and/or some other trust "agent." This can be helpful if the trust beneficiary is a poor money manager or is mentally incapacitated or has an "over-reaching" spouse.

It is typical (although not always the case) for the Trustor who creates a Descendant's Trust for a child or grandchild ("descendant") to allow each descendant who is the primary beneficiary of a Descendant's Trust to become the sole Trustee of his own trust upon reaching a certain age. In many cases, the descendant first serves as a Co-Trustee with someone else (an older, wiser adult or a professional Trustee) as a "training period" before taking over as the sole Trustee. If the Descendant's Trust is properly drafted, it is not a problem for the descendant to serve as the sole Trustee of his own trust. However, the descendant who is serving as sole Trustee needs to be very careful to administer his Descendant's Trust in a smart way to preserve the benefits of the trust.

Most Descendant's Trusts allow distributions for the health, education, maintenance and support of the primary beneficiary and his descendants. In general, distributions should be made for "expense items" (food, clothing, shelter, medical bills, tuition) on an "as needed basis" and "investments" should be purchased as assets owned by (i.e., inside) the trust. Once the Trustee makes a *distribution* of funds or other assets out of the trust, those distributed funds/assets cannot be put back into the trust. And once distributions are made out of the trust, the benefits described above no longer apply to those distributed funds/assets (because they are no longer trust assets). An example of a child who made a poor distribution decision as Trustee of his Descendant's Trust will be provided later in this newsletter.

Contingent Trusts. Let's contrast Descendant's Trusts with "Contingent Trusts." Contingent Trusts are very simple trusts--usually "single beneficiary" trusts--used to prevent a beneficiary who is "too young" from gaining control of the assets he has inherited too soon. Contingent Trusts are an absolute minimum type of trust that should be included in every Will and trust instrument to avoid a legal guardianship in the event a minor (a person under age 18) is entitled to any assets. The Trustee of a Contingent Trust manages the trust until the beneficiary reaches the specified trust termination age, at which time the trust terminates and *all of the trust assets are distributed to the beneficiary, outright and free of trust.* Most Contingent Trusts terminate when the beneficiary reaches age 25 or 30. Some Contingent Trusts are drafted to terminate in stages, such as 1/3 when the beneficiary reaches age 25, ½ of the remaining trust assets (another 1/3) at age 30, and the balance of the trust assets (the final 1/3) when the beneficiary reaches age 35. During the existence of the Contingent Trust, the Trustee will make all investment decisions and all distribution decisions. Most Contingent Trusts allow distributions to be made for the beneficiary's health, education, maintenance and support. Because the Contingent Trust will terminate while the beneficiary is still living (when the beneficiary reaches the specified age), the Contingent Trust only provides divorce protection and lawsuit protection for the trust assets for a short period of time. Consider the fact that divorces and lawsuits happen just as often when people are in their 40s, 50s and 60s as when they are younger.

Descendant's Trusts provide all four of the benefits listed above *for the beneficiary's entire lifetime*. In addition, if the descendant becomes the Trustee of his own trust, he will have both control over, and use of, the trust assets, for life, but with the benefits noted above. Because Descendant's Trusts last for the beneficiary's lifetime, it is important to draft the trust with as much flexibility as possible. In summary, Descendant's Trusts are "better quality trusts" than Contingent Trusts in many respects. Most wealthier people use Descendant's Trusts, rather than Contingent Trusts, for their children and grandchildren. If the value of the assets is large enough, a Descendant's Trust is a better choice.

What Are the "Downsides" of Descendant's Trusts? In regard to a typical Descendant's Trust, there is one "operating cost" and one potential disadvantage. As noted above, the type of Descendant's Trust we are discussing in this newsletter is an irrevocable, non-grantor trust. Because one of the purposes of the trust is to protect trust assets from "creditors' claims" (whether the "creditor" is a spouse in a divorce or a plaintiff in a lawsuit), most Descendant's Trusts are drafted having a "discretionary" distribution standard. In other words, the trust does not mandate that all income or even a specified amount be distributed out of the trust to the beneficiary each year (if it were to say that, whatever the beneficiary is absolutely entitled to receive, his creditor can get). Most Descendant's Trusts give the Trustee *discretion* regarding the making of distributions from the trust. In other words, the Trustee has discretion whether to distribute the income (and principal) out of the trust or keep the income earned by the trust assets (and the principal) in the trust. If the Descendant's Trust has multiple beneficiaries, the Trustee is also given discretion to make distributions to any of those beneficiaries. Because the trust is drafted to give the Trustee *discretion* regarding distributions, that makes the trust a "complex trust" for federal income tax purposes. Although the term, *complex trust*, makes it sound like the trust is hard to understand, it is simply an income tax classification.

In any event, a Descendant's Trust must file an income tax return each year because every year the assets in the trust will earn income and that will be brand new income that nobody has ever paid income taxes on before. Someone will pay income taxes on that income. The income tax return for the trust, i.e., a Form 1041, will report (i) how much income was earned by the trust assets that year and (ii) who got that income (i.e., to whom was that income distributed, if anyone). As noted above, if any part of that year's income is distributed out of the trust to a permissible beneficiary, that beneficiary will pay income taxes on the portion of the income he received in his own tax bracket. Correspondingly, the trust will get a deduction for the income distributed out of the trust. It is not a "double tax"–it's an "either/or" situation. Therefore, the "operating cost" of a Descendant's Trust is the fee paid to the CPA to prepare the Trust's annual income tax return. In our opinion, a trust income tax return should always be prepared by a CPA because it is not the type of income tax return a lay person can prepare competently. And, in our opinion, in view of the significant benefits provided by a Descendant's Trust, the operating cost is well worth it.

The "disadvantage" of a Descendant's Trust results from one of the advantages of a typical Descendant's Trust. As noted above, the way many Descendant's Trusts are drafted, the assets remaining in the trust when the primary beneficiary dies will not be included in the beneficiary's estate for federal estate tax purposes. That exclusion from the beneficiary's estate means that the assets held in the trust will not receive an "adjustment" to tax basis on the beneficiary's death. Many people refer to the adjustment to the tax basis of "capital assets" at death as a "step up" in basis. That is not technically correct. As we have explained before, if a capital asset is included in a person's estate at death, that asset must be valued at its fair market value for federal estate tax purposes as of the person's date of death (or, in certain cases, as of the alternate valuation date). That value becomes the new tax basis (also referred to as "cost basis") of that asset for federal income tax purposes. It is true that, in many cases, the date of death value of an asset is higher than its original cost basis. So, in those cases, there would be a "step up" in basis at death, but that is not always true.

As a reminder (*and in very general terms*), a capital asset is an "after-tax" investment-type asset, such as real estate, stocks, bonds, mutual funds, etc. When a capital asset is sold, the tax basis is subtracted from the sales price to determine whether there is a capital gain or a capital loss on the sale. Obviously, in the case of an asset that has appreciated in value, the higher the tax basis, the lower the capital gain. Therefore, obtaining an adjustment to tax basis at death (especially for appreciated assets) is a very valuable thing. It is even more valuable if no federal estate taxes have to be paid to get it.

Right now, the federal estate tax exemption amount is $11,180,000, which is a basic exemption amount of $10 million, with inflation adjustments calculated from a base year of 2011. As noted in prior newsletters, however, the law that provided this exemption amount is scheduled to "sunset" (expire) at midnight on December 31, 2025. On January 1, 2026, the estate tax exemption amount will revert back to a base amount of $5 million, with inflation adjustments starting from 2011. Of course, Congress might reduce the estate tax exemption amount sooner than that. In fact, some Democrats in Congress have already proposed dropping the estate tax exemption amount to $3.5 million, which was the exemption in the year 2009. So, keep in mind when evaluating this "disadvantage" of Descendant's Trusts that, if the federal estate tax exemption is reduced, avoiding federal estate taxes will be more important than obtaining an adjustment (possible step up) in tax basis for the assets in the Descendant's Trust when the beneficiary dies. The estate tax is worse than the capital gains tax because it is a tax on "principal" (the value of the assets themselves), while the capital gains tax is merely a tax on gain in value. In addition, the current estate tax rate is 40% while the current top long-term capital gains tax rate is 20% (without regard to the 3.8% net investment tax).

One consideration that is often overlooked in these discussions is the ability to manage capital gains and losses on an ongoing basis. That is not always possible, of course, but the average Descendant's Trust primarily owns marketable securities and, perhaps, some real estate. A dedicated Trustee, with the help of an astute financial advisor, can manage capital gains and losses each year (i.e., selling long-term gains and losses that offset each other), so that, when the primary beneficiary dies, the lack of an adjustment to tax basis for the trust assets might not be that significant.

Alarming True Story. A 44 year old doctor was the sole Trustee of a $4 million Descendant's Trust created for him by his parents when they died. He indicated that he understood the benefits of his Descendant's Trust and the idea of just distributing from the trust what was needed at the current time, allowing the rest of the assets to remain safely in the trust for future use. One day, he made a distribution of $2 million out of his trust and put it into a joint account with his wife. Six months later, his wife filed for divorce. The doctor called me and asked if he could put the $2 million back into his trust. I told him, "No" (I certainly didn't want the rest of his trust to be *tainted* by that "personal contribution" to the trust). So, he lost $1 million in the divorce and the other $1 million held in his personal account was now available to plaintiffs who might sue him for medical malpractice. There was no reason for the doctor to do what he did. The entire trust was "his" and under his "control." What was he thinking?!

Mistakes Trust Creators Make That Prevent Assets from Going into Descendant's Trusts. When parents, grandparents or others create Descendant's Trusts that are to be set up and funded when they die, they need to be sure that the assets they want to go into those trusts will "make it into" those trusts. This is becoming more and more of a problem due to the "non-probate revolution."

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People are so "afraid" of probate that they are arranging all their accounts and other assets "to avoid probate." That means *those assets will avoid their estate plan in their Will*. Thus, if their Will creates Descendant's Trusts, but all assets, including real estate, brokerage accounts, bank accounts, etc., are titled or arranged in a way that "avoids probate," none of the assets will end up going into the Descendant's Trusts created in their Will. The most common arrangements we see that cause this problem are joint accounts titled to include a "right of survivorship" (JTWROS), "Pay on Death" (POD) arrangements and "Transfer on Death" (TOD) arrangements. We have written about the problems caused by these arrangements many times in the past. So, be very careful how you title your assets. One solution may be to place your estate plan in a revocable trust and then retitle your real estate, brokerage accounts and other assets into the name of your trust.

In addition, the beneficiary designation forms for your "beneficiary designation assets" must be carefully structured if you want any of those assets to go into the Descendant's Trusts you are creating. The four beneficiary designation assets are (i) life insurance, (ii) employee benefit plans, (iii) IRAs, and (iv) annuities. These assets are distributed when you die pursuant to the beneficiary designation on file with the company administering the asset. Note that a Descendant's Trust can be drafted as a "qualified see-through trust" so that there is no acceleration of income taxes for employee benefit plans and IRAs made payable to the trust.

In conclusion, think about using Descendant's Trusts for your descendants. They really might be the "have your cake and eat it, too, trust."

HAPPY HOLIDAYS! The holidays will soon be here. We want to wish everyone Happy Holidays and we also want to thank all of our clients and referral sources for a wonderful year.

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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