BUILDING FLEXIBILITY AND CONTROL MECHANISMS INTO THE ESTATE PLAN – DRAFTING FROM THE RECIPIENT'S VIEWPOINT

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I. INHERITING IN TRUST IS BETTER THAN INHERITING OUTRIGHT[1]

Many families with substantial wealth (as well as some of their advisors who should know better) are unaware of or simply overlook a fundamental fact of estate planning. The key concept they unfortunately so often miss is that assets received in trust are much more valuable to the inheritor or donee then those same assets received outright. Solely because assets are received and continue to be held in trust gives those assets many advantages that cannot exist for assets received outright. In order to achieve these results, it is essential that the planning and documents be put in place before the transfer. A person other than the beneficiary, including the spouse of the proposed recipient, can set up, and fund the trust. This shelter is not available for a person to do for himself once he is individually entitled to the property.

The benefits that can be achieved by receiving and retaining gifts and inherited assets in an irrevocable trust (rather than being commingled with a donee's own assets) are significant. A perpetual dynastic trust will extend these enhancements for multiple generations, subject only to the applicable rule against perpetuities, if any. These improvements fall into three categories –

A. A trust "shelters" inherited assets from the donee's "predators".

[1] See Richard A. Oshins and Steven J. Oshins, Protecting and Preserving Wealth Into The Next Millenium, Trusts and Estates Magazines, page 52 (September, 1998) and page 88 (October, 1988).

Assets put into a trust by someone other than the beneficiary himself have the advantage of being sheltered from the reach of many of the beneficiary's predators – such as a divorcing spouse, a creditor in bankruptcy, and the IRS (in the case of certain trusts). Thus, where the "transferor" of assets gifted or bequeathed to such a trust is someone other than the beneficiary, eg. the beneficiary's parent, aunt, uncle, or grandparent, use of the trust "enhances" those assets (as compared with an outright gift or bequest to the donee). In other words, the trust itself makes the transferred assets more valuable by protecting them from the reach of many of the donee's would be claimants. These shelter benefits include –

1. <u>Protection from donee's death, gift, and generation-skipping taxes</u> (but only insofar as the trust is GST "exempt").

   a. If the trust is an "exempt trust", no transfer taxes of any kind will be levied when the donee passes those trust assets on to others (whether outright or in a continuing trust), either during his lifetime or on death. The "exempt" status of the trust (and its successor trusts) continues no matter how large the value of the trust's assets may grow through successful investment performance and/or income accumulations.

   b. Thus, the full value of the trust can be passed on to the donee's family or, within the limits of the donee's special power of appointment, to or for the benefit of any particular person or persons selected by the donee.

   c. Without such protection (and assuming the donee would otherwise be in the 50% estate tax bracket), the estate and GST taxes together take 75% - leaving only 25% for the grandchildren.[1]

2. <u>Protection from donee's creditors, bankruptcy, and divorce</u> (subject to some state law aberrations). As the asset protection maximum goes, "If you don't own it, no one can take it from you."[2]

   a. In the event of the donee's divorce, those third party transferred assets, while they remain in such a trust, are not "marital property" to be equitably divided by the court. Likewise, such "in trust" assets are not a part of the donee's estate for purposes of determining a surviving spouse's elective share rights.

[1] Exhibit A attached at the end of this explanation (entitled "The Power of Compound Growth") compares $1M left outright (after compounding for 120 years at total return growth rates ranging from 6% to 10%) with $1M left in trust. The difference is the estate tax to which the outright inheritance is subjected – assumed to be a 50% tax every 30 years.

[2] Howard D. Rosen, 810 T.M., Asset Protection Planning, BNA Tax Management Portfolio at A-1.

b. The donee's creditors cannot reach those assets. Lifetime or testamentary gifts made in trust (rather than outright) insulate those assets from the reach of the donee's creditors – which also provides some "peace of mind" benefits. For example –

- If the donee is a doctor, lawyer, architect, CPA, or other professional, it is reassuring to know that those gift or inherited assets are held in trust and thus will be sheltered from the donee's potential professional malpractice liability.

- Having the donee's "core assets" (inherited family wealth) sheltered in such a trust provides another frequently overlooked benefit. It allows the donee (or the donee's spouse) to borrow for business or investment purposes without putting those core assets at risk on account of the personal guarantees that lending institutions typically require of business owners and their spouses.

- Alternatively, a favorable business opportunity or other predictably profitable venture might be acquired by the trust itself as an investment of the trust with the wealth inurement being protected from liability and transfer taxes by the trust wrapper.

B. <u>Incapacity and probate avoidance benefits.</u>

As compared with an outright gift or inheritance, if a donee receives (and keeps) gifted or bequeathed assets in a trust, those assets are protected by the trust:

1. From the mistakes and "improper influences" that often result from a donee's"

a. Inability (that is, immaturity, inexperience, poor judgement, etc.),

b. Incapacity (including legal incapacity to act due to not having attained legal age under state law), or

c. Possible substance abuse addition, and

2. From probate on the donee's death.

a. On the death of a trust's beneficiary, the trust simply continues to administer its assets, privately and without court involvement of any kind, for the beneficiary and his successor beneficiaries.

b. Avoidance of probate under any of those circumstances (i) preserves privacy, (ii) reduces expense, and (iii) generally results in a more expedient administration of the assets.

C. <u>Inherited wealth often benefits from the respect shown by its segregation.</u>

Inherited wealth received outright often loses its identity due to commingling. On the other hand, when wealth is received and retained in trust, there is the increased propensity to preserve the wealth for the benefit of future generations.

1. This segregation advantage seems to apply even though, after attaining certain ages, the donee succeeds to full control over his trust and the assets that were left for him and his family.

   a. If a donee/beneficiary has a fund which is ample and protected from predators, the beneficiary is better able to aggressively use wealth shifting devices to reduce his own estate, due to the fact that his well-being is protected by the assets in the trust.

D. <u>Conclusion-Inheriting in trust is *always* better, *provided the beneficiary has adequate control over his trust*!</u>

A donee-beneficiary whose inheritance is received in trust will almost certainly be pleased by the added benefits that the trust makes possible (when compared with an outright inheritance). However, this will often be true only:

- If either initially or on attaining a properly mature age, the beneficiary will possess reasonable controls over his trust (ie, a "Beneficiary Controlled Trust"-"BCT"), and sometimes only
- If someone with expert practical knowledge of the trust has taken the time to be sure that the donee-beneficiary fully understands how the benefits made possible by the trust will enhance his personal well being.

1) <u>The importance of control to a donee-beneficiary's peace of mind.</u>

Control is a very important element in determining how happy (or frustrated) a beneficiary may be with the gift or inheritance trust he has received. Depending on the circumstances, a donee-beneficiary will often be discontented with a trust gift or inheritance unless if he has some reasonable level of control over his trust.

2) <u>Nevertheless, in some cases a donee-beneficiary may not have control</u>.

If the terms of the trust do not permit the beneficiary to ultimately succeed to reasonable controls over his trust, he may wish that this particular gift or inheritance had come to him outright rather than in trust. Before making such a judgment, however, the beneficiary should seek to understand the reasons why he was not given certain otherwise normal beneficiary controls. The absence of such controls may be the result of:

(a) **Inadvertence** (as where the trust was drafted following traditional, rather than contemporary, patterns and choices relating to beneficiary controls),
(b) **The beneficiary's personal circumstances** (these sometimes suggest the need to limit certain controls that would otherwise be given to a beneficiary), or
(c) **A desire on the trust's creator's part** to have family wealth preserved and passed on to others (in other words, an outright inheritance would have been out of the question, regardless of the other circumstances).

3) If the desire of the transfer is to improve the gift, a BCT should be the choice. If it was not for the tax, divorce and other benefit that an "in trust" gift or inheritance can provide, if the transfer would be made outright, the transfer should be made in trust.

- For mature, competent potential recipients a totally discretionary BCT should be the vehicle of choice,

- If the beneficiary has not attained a properly mature age or responsibility, the trust should become a BCT at the projected age of such maturity. Certainly, this should be favored over a direct distribution.

In any case, the donee-beneficiary should at least be pleased by the asset protections and other benefits afforded by the trust.

II. WHAT IS A "BENEFICIARY CONTROLLED TRUST" ("BCT")

A. An Overview.

1. The "Pipe Dream"[3]

a. If it were attainable most property owners would love to have the ability to place their property into a structure whereby they -

- Could manage and control it;

[3] Drafting California Irrevocable Trusts, John R. Cohan, ¶ 8.11

- Use the property, and income from it, for whatever purpose they desire;

- Be able to give the property to whomever they want to, whenever they want to, however they want to, with or without strings;

- And protect the property against lawsuits and taxes

b. Many property owners would like to pass their wealth to their children and more remote descendants (at such time or times, that they perceive that these donee's have attained sufficient maturity and responsibility) where the donees could also obtain the foregoing beneficial enjoyment of the wealth. The beneficiary controlled trust gives the primary beneficiary (and those succeeding to the status of being the primary beneficiary) control and enjoyment of the transferred property, including its income and growth virtually equivalent to outright ownership over the property without the exposure to predators.

c. The desire is to avoid the exposures of outright ownership while also avoiding the restrictions and controls inherent in the traditional trust arrangement gives the recipient/beneficiary the best of all worlds-full enjoyment without exposure.

2. <u>The BCT concept is an attempt to answer those questions.</u>

The "beneficiary controlled trust" has evolved as an attractive middle ground answer to those basic questions. It can be designed to give a beneficiary control virtually tantamount to outright ownership as well as insulation of the assets from taxes and creditors, provided the trust is property setup and funded by someone other than the beneficiary.

3. BCTs are a way for a beneficiary (i) to have the benefits of inheriting in trust, (ii) for life, (iii) with full control at the "right" time.

Briefly summarized, a BCT gives the primary beneficiary:

a. All of the benefits of an inheritance "in trust",

b. Which will continue for the beneficiary's entire lifetime, and

c. Either initially or ultimately, the beneficiary will be in full control of the trust - the controls over the trusts assets and operations approaching outright ownership.

4. A typical perpetual BCT continues this structure into for as long as the trust continues, giving the control to the senior generation on a per stirpital basis, subject to alteration by the use of a special power of appointment.

B. <u>How a BCT differs from traditional trusts.</u>

1. Traditional trusts.

Traditional trust for an adult child typically provide that:

a. The income from the trust's assets shall be distributed periodically to the child,

b. The trust's principal may be invaded, in the trustee's discretion, if necessary, to meet certain standards – such as, "if needed for the child's health, education, and support in reasonable comfort", and

c. The trust continues in existence only until its assets are distributed to the child, often in fractional amounts as certain specified ages are attained such as, ½ at 25 and the rest at 35.

d. In theory, these distributions are expected to be made at the time of the beneficiary's anticipated ages of maturity.

e. Distributions have the residual effect of moving the assets from a protected status to an exposed environment.

2. The three key characteristics of a typical BCT.

a. A BCT is a "totally discretionary" trust.

b. It is a trust arrangement that continues (i) for the child's lifetime and (ii) for the successive lifetimes of the child's descendants.

c. When specified ages are attained, instead of requiring outright distributions to the child, a BCT puts the child "in control" of the trust.

However, this transfer of control may be deferred if the child's parents (or their designees) believe the child is not currently able to take on the responsibilities of control. This deferment might be until (and to the extent) the age(s) that outright distributions would have been made had a traditional trust been used.

C. The approach of the BCT

1. The premise on which the BCT concept rests

The following statement best expresses the premise on which the base form BCT rests.

> "If it were not for the benefits that an "in trust" inheritance can provide, I would leave it all outright."

A pure BCT is intended to be "living proof" of the conclusion that inheriting in trust can be far better then inheriting outright.

2. The BCT's primary goal is to maximize "in trust" benefits.

The BCT's totally discretionary distribution pattern, by its very nature, maximizes "the benefits that an in trust inheritance can provide". As pointed out in the discussion of that distribution pattern, the use of this pattern also means that the BCT's primary goal will be achieved with maximum flexibility to meet changing circumstances.

3. The essence of the BCT concept is beneficiary control.

The basic premise, "I would leave it all outright", expresses the key condition or prerequisite of the arrangement- beneficiary control and beneficiary responsibility. That means "full control". The beneficiary as family trustee would control all non-tax sensitive decisions as well as the identity of the independent trustee, who would control the tax sensitive decisions.

4. What to look for in an independent trustee.

From a purely technical point of view, an independent trustee should be an individual or institution:

- Who meets (i) the tax that is, IRC section 672(c)] and (ii) creditors' rights criteria of independence – and, if an individual is to act, usually one
- Who is knowledgeable in investment, business, or tax matters.

However –

a. <u>"Independence" does not require a confrontational relationship.</u>

Rather a cooperative relationship is what the trust's creator intends – with the trust's primary beneficiary (eg; the adult child) normally becoming, in due course, what is described below as the "top of the control list person".

b. <u>The independent trustee should be "a caring friend".</u>

Ideally, the independent trustee should be "a caring friend' of the primary beneficiary, trusted and trusting – a person:

(1) Who seeks to understand and be understood and

(2) Who has experience, maturity of judgement, and a sense of the enduring values of the beneficiary's family.

(3) The independent trustee may be the primary beneficiary's best friend.

D. <u>BCTs keep inherited assets in trust over mulitple lifetimes.</u>

A BCT is a trust arrangement that recognized the benefits that can be achieved by the continued holding of inherited wealth in trust, not just for a child's lifetime but also for the successive lifetimes of the child's descendants.

1. <u>Most traditional trusts distribute outright at certain ages.</u>

In the case of traditional trusts, the governing document often directs that, upon the trust beneficiary's attainment of a certain age (or certain ages), part or all the trust's assets shall be distributed outright to the beneficiary. The outright distribution of trust assets, in affect and to that extent, terminates the trust – and thus also terminates the benefits that would otherwise have continued if the assets had been kept in trust.

2. <u>A BCT instead gives the beneficiary control over the trust's assets.</u>

What makes the BCT concept so advantageous is that, instead of terminating the trust at a certain age or on someone's death, the trust continues on indefinitely (with the primary beneficiary in full control of the trust and its assets). In this way, the BCT preserves for the beneficiary (and his descendants) all of the benefits that continuing an inheritance in trust can achieve (as described in part I above).

D. <u>At the "right" time, "full control" over the BCT shifts to the primary beneficiary (eg; the child).</u>

A unique aspect of the beneficiary controlled trust concept is the way in which full control over the trust may be gradually shifted to the trust' primary beneficiary.

1. <u>In traditional trusts, the "dead hand" controls.</u>

During the period that a traditional trust continues, whether it is until certain ages are attained or for the child's entire lifetime, the child typically has no voice in the trust's management.

b. The "dead hand" directions of the testator usually continue throughout the traditional trust's existence.

c. Such "control from the grave" is usually evidenced by:

- Rigid distribution provisions,

- An unchangeable trustee appointment, and

- The fact that often the beneficiary is not a trustee and has no special power of appointment.

III. <u>PERPETUAL(OR DYNASTIC) BENEFICIARY CONTROLLED TRUST ("PBCT") FORMAT</u>

A. <u>The "perpetual or dynastic trust" concept</u>

A "perpetual or dynastic trust" is any long term, noncharitable trust.

1. <u>It is a "trust arrangement" (not a single trust).</u>

Actually, in almost all cases, this type of trust should be referred to as "**a trust arrangement".** This is because the governing trust document normally creates separate trusts, one for each family branch (and, in due course, for each lower generation family branch), depending on the makeup of the grantor's family. The reasons for having separate trusts for each family branch are discussed below.

2. <u>The rule against perpetuities and its effect</u>

Dynastic trusts are normally expected to continue in existence for the maximum time period allowed by the rule against perpetuities.

3. <u>A growing number of states have repealed the rule</u>

In a growing number of states, the rule against perpetuities has a trust created in one of those states may continue in perpetuity as a perpetual trust arrangement going on indefinitely for as long as there are assets and one or more beneficiaries.

B. As noted above, the term "perpetual or dynastic trust" typically refers to an expanding group of trusts (which might be referred to as a trust arrangement).

- At a minimum, the generation-skipping transfer (GST) tax requires that pairs of trusts (GST tax exempt and nonexempt) be established.

- As the family branches of beneficiaries expand, additional trusts or pairs of trusts are desirable from an administrative and family harmony perspective
- If spouses of family member beneficiaries also are or may become beneficiaries, even more separate trusts may be appropriate.
- Finally, if a plan of lifetime giving is undertaken, the PBCT arrangement is the appropriate receptacle for gifts (both annual exclusion gifts for the benefit of children and grandchildren and major gifts). Although separate trusts are suggested if the gifts were to create different income tax treatment.[4]

The following is a brief description of the patterns utilized in our practice with respect to PBCT arrangements.

A. <u>Threshold decisions</u>

Preliminary questions that must be answered before the trust agreement can be prepared include, in the case of a married couple, who the grantors of the PBCT will be. Also, whether (and to what extent) sons in-law and daughters in-law should be provided for and what the scope of the powers of appointment to be given to children and lower generation beneficiaries should be.

1. <u>Should both husband and wife be grantors?</u>

In the case of a trust (that is, one that benefits only descendants and future generations), there are generally no income, gift, or estate tax concerns in having a husband and wife serve as cograntors of that trust arrangement because neither cograntor is a beneficiary provided, that the trust is not an income grantor trust as to either spouse or as to a beneficiary under IRC 678.

a. <u>Reasons to have a married couple be cograntors</u>.

A trust created for the benefit of one spouse by the other spouse will have no adverse creditor or transfer tax implications for income tax purposes, the trust would be a grantor trust during the lifetime of the beneficiary spouse unless distributions to the spouse are subject to the consent of an adverse party. IRC 677.

b. <u>Reasons not to have a married couple be cograntors</u>

In the case of a trust designed to be a "grantor trust" for income tax purposes, it may be difficult, from an accounting perspective, to determine what portion of the fund is "owned" by the surviving grantor for income tax purposes.

2. <u>Establishing a separate trust (or trusts) for each family branch</u>

[4] It is important to separate exempt and non exempt trusts for GST tax purposes, to avoid an accounting nightmare it is important to be sure that there is single income tax treatment for entire trust. Thus a trust which is a grantor trust as to the beneficiary pursuant to IRC 678 should not be the recipient which would be taxed to someone other than the beneficiary or the trust itself.

One key suggestion is to have a separate trust, with its own set of trustees, for each "family branch". For many reasons (see below), this kind of trust plan is usually preferable to a single trust shared by all the family branches (all of whom are then forced to endure working with one set of trustees who must please everyone). There are really two concepts at work here:

- Separate Trusts, one for each "family", and
- A separate set of trustees for each separate trust.

At the outset, the trustees of all of the trusts may often be the same (typically one of the parents, with our without one or more other persons of the parents' choice, until neither parent is available to serve). After the parents are gone, if the trust objectives and the child's maturity so permit, each child often takes over responsibility for his or her own trust, with the result that the child and/or another person of the child's choice often become the trustees of that child's trust (without regard to what each other sibling may do by way of trustees for that sibling's own trust).Thus each primary beneficiary should have his or her own separate trust and trustees.

a. The benefits of separate trusts for each family branch.

There are many benefits of having separate trusts with a separate set of trustees for each trust. For instance –

(1) Avoiding sibling conflicts.

First, separate trusts and trustees will avoid sibling conflicts. Having to get a brother's or sister's approval of trust investments or administrative actions can be intrusive on the privacy rights of each and lead to family disharmony. Each family branch needs to choose its own trustees (just as it chooses its own attorneys, accountants, bankers, and so on).

(2) Trust portability

Second, each primary beneficiary's own trust becomes portable. If he or she moves to another state (or country), the trust's administration can move to that state with the beneficiary (leaving the brothers' and sisters' separate trusts back home undisturbed).

(3) Varying distribution patterns

With separate trusts, distributions to one child do not have to be "matched" by equivalent distributions to each other child – or treated as "advances" on that child's ultimate share – as would be necessary with a single "pot" trust in order to fairly treat all children alike.

B. The need for separate GST "exempt" and "nonexempt" trusts

In the typical postdeath estate planning situation (and even in the case of many inter vivos irrevocable trusts), the GST tax is having the unfortunate effect of doubling the number of separate trusts expected to come into existence. In order:

- To protect allocations of the trust creator's GST exemption from being "wasted" on trust distributions that are made to nonskip persons and

- To allow assets thus exempted from future GST taxes for all generations to continue in trust for the rule against perpetuities period (or beyond),

practitioners are having to plan for separate "exempt" and "nonexempt" trusts for each primary beneficiary at each level. There is no prescription to having the same trustee arrangement as to each pair of trust. Considering the purposes such a pair of trusts are to serve, the trustees of each should be the same.

IV. <u>Trust Design – "Totally Discretionary"</u>

A. <u>The "totally discretionary" distribution pattern should be the design of choice</u>.

Selection of a totally discretionary distribution pattern for a child's or grandchild's gift or inheritance trust means that an independent trustee will at all times have the power, in such trustee's absolute discretion, to distribute any part, or even all, of the trust assets, and to or for the benefit of any members of the beneficiary's family (or trusts for the benefit of any of the foregoing) to the child or grandchild (as that trust's primary beneficiary). The following are some observations regarding this distribution pattern.

1) <u>Offers the greatest flexibility</u>

The absence of any standards (or even any guidelines of any kind whatsoever) for the making of distributions makes the distribution pattern the most flexible for dealing with future family circumstances.

2). **<u>Insulates the trustee from litigation</u>**

The total absence of standards and guidelines also serves to insulate the independent trustee to the greatest extent possible from litigation that would attempt to second guess the trustee's exercise of discretion in making (or failing to make) distributions.

3) <u>Equals outright ownership if/when beneficiary gains "full control"</u>

If and when "full control" over a totally discretionary trust has been given to the trust's primary beneficiary, a totally discretionary distribution pattern provides the beneficiary with almost the same enjoyment of the trust's assets as outright ownership would provide. Such a shift over to the primary beneficiary of what amounts to full control normally occurs at the "right" time.

4) <u>Requires an IRC section 672(c)(2) Independent trustee</u>

Achieving the tax and other shelter benefits described in paragraph 1a(1) above requires that the totally discretionary distribution power be held solely by a trustee who is neither a donor or beneficiary nor related or subordinate to either within the meaning of IRC section 672(c)(2).

5) <u>Alternative distribution pattern – "Entitlement Trusts"</u>

The alternative dispositive scheme all to often selected is a trust in which some entitlement to distributions is specifically set forth (giving the beneficiary certain measurable rights to receive distributions). Because the beneficiary has defined enforceable rights, flexibility is reduced, creditor protection is diminished (since creditors may step in the beneficiary's shoes and enforce their rights against the beneficiary's entitlement), and many tax planning opportunities are lost.

6) <u>Usually the Requirement of Impartiality is Waived</u>

Traditional trust theory incorporates a fiduciary duty of impartiality upon the trustee. In a "I'd give it outright but for the tax and creditor benefits trusts offer" situation the trust's creator generally will want to favor the "primary beneficiary" with the remainder men receiving "whatever is left" at the primary beneficiary's death.

B. <u>Determining the extent of the beneficiary's controls over the trust and its assets.</u>

A practitioner who is assisting his client with the creation of a trust will often be asked by the client to make recommendations regarding various controls that might or might not be given to the trust's primary beneficiary. The choices and combinations are virtually infinite. The following overview is intended to highlight some of the more significant considerations:

1. **<u>Kinds of controls</u>**.

The kinds of controls that a beneficiary might be given over his trust can be divided into three general categories-

(a) <u>Dispositive controls-meaning special powers of appointment.</u>

In view of the tremendous flexibility in dealing with changing circumstances that special powers of appointment[4] provide, it is our judgement that, absent unusual circumstances, each trust's primary beneficiary should have a special power of appointment over his trust, either broad or restricted. In our practice, such powers are exercisable both on death and during

[4] Special powers of appointment are discussed as a part of the flexibility topic in part IV below.

lifetime. This will permit the primary beneficiary (as the holder of the power), within the specified limits, to:

(1) Make gifts of the trust's assets, either outright or in trust, during the remainder of the beneficiary's lifetime.

(2) Direct what happens to the remaining trust assets on the beneficiary's death. In other words, within the limits specified in the power, the beneficiary has what amounts to a "rewrite power" over all of the trust's provisions.

From the point of view of a future generation beneficiary of an inheritance trust, the so called "golden rule" ("he who has the gold rules") is brought to life by the predecessor primary beneficiary's power of appointment-even if viewed only as "a power to disappoint".

C. <u>Administrative and investment controls</u>

The most extreme variations in the extent to which a trust's primary beneficiary may or may not have some control involve the management of the trust and its investments. As noted below, in "traditional trusts", the primary beneficiary rarely has any voice in the trust's management. Modern trusts (particularly a BCT), on the other hand, often give the primary beneficiary every possible control. And, of course, special circumstances such as the beneficiary's capabilities, the settlor's outlook, family tradition, and so on, will have their effect as well.

(1) <u>Traditional trusts</u>

Historically, trusts have been viewed primarily as a way to protect immature or otherwise dysfunctional beneficiaries who are unable to protect themselves.

(a) Traditional trusts for children and grand-children, therefore, have usually sought only to protect them until they attain a proper age of maturity. Such trusts typically direct that, upon the trust beneficiary's attainment of a certain age (or certain ages), part or all the trust's assets shall be distributed outright to the beneficiary.

(b) The resulting outright distribution of trust assets, in effect (to that extent), terminates the trust.

(i) Ignored is the fact that terminating the trust results in terminating the shelter and other benefits that were made possible by receiving the gift or inheritance in trust. Unless there is a good reason or thus terminating the trust as certain ages are attained, doing so needlessly wastes the benefits that otherwise could have been continued for the rest of the beneficiary's lifetime.

(ii) Such a continuation of those inheritance benefits, for life, could have been accomplished by simply putting the primary beneficiary in control of his trust and, instead of distributing the assets to the beneficiary, retaining them in trust under the child's control, with all of the benefits continuing for the rest of the child's lifetime.

(b) <u>Lifetime trusts intended to take advantage of the shelter and other benefits created by any trust gift or inheritance</u>

Modern trusts, intending to continue the shelter and other advantages of any trust in gift or inheritance, typically adopt a quite different approach.

(i) First, when the appropriate specified age of maturity is attained, such modern trusts provide for the beneficiary to receive, in stages if more than one age is thought appropriate, control over the trust (rather than distribution of the trust assets).

(ii) This shift of control is accomplished by treating that attainment of age as the time when the trust's primary beneficiary is to become the trust's family trustee.

(A) As family trustee, the primary beneficiary will then have control over the trust's investments and administration (the independent trustee, while still responsible for making investment recommendations, is exculpated as to actions taken at the direction of the family trustee).

(B) In other words, as family trustee (and therefore acting in the best interests of the trust and in furtherance of its purposes), the primary beneficiary is given the power (by the governing trust agreement) to require that the family trustee's decisions control the trust's administration within specified limits. These limits require the family trustee to:

(I) Hear the views of the independent trustee prior to deciding issues and

(II) Recognize that certain decisions (for example, discretionary distribution decisions) are vested solely in the independent trustee acting alone.

(3) <u>Controls relating to the availability of trust assets for the beneficiary's use and enjoyment</u>

A "modern" trust's primary beneficiary is often given what might be referred to as "full control" over his trust. The free use and enjoyment of trust owned property also may be given in the sole discretion of the primary beneficiary/family trustee. However, the availability of distributions from a totally discretionary trust, prior approval (or concurrence) by the trust's independent trustee is till required.

(a) <u>"Full control".</u>

Subject to concurrence by the independent trustee, "full control" means **the maximum control permitted** by the laws that shelter a trust's assets from a beneficiary's "predators" – that is, from:

(i) Creditors,

(ii) An overreaching spouse, and

(iii) The IRS

(b) <u>Removal rights over the independent trustee</u>

Most trusts being drafted currently, especially those that use family and independent trustees, provide a mechanism for trustee removals. Typically, the family trustee has the power, for any proper reason, to remove the independent trustee[6] and to fill any vacancy in that trustee office with a properly qualified successor and independent trustee.

(c) <u>The use of trust owned property</u>

Full control also implies that a trust's primary beneficiary shall have the right to use certain trust assets on a preferential basis. For example- the beneficiary may use, on a rent-free basis (except for utilities and sometimes maintenance), primary and seasonal **homes, boats, etc.** that are bought and owned by the trust for that purpose.

b. **<u>Circumstances often determined what control a beneficiary can have</u>**

The extent to which a beneficiary may ultimately be given control over his trust will also depend on various circumstances at the time the trust was created. These include:

(1) **The wishes of the trust's creator** (for example, a desire to limit beneficiary controls in order to assure that family wealth be preserved and passed on),

(2) **The beneficiary's personal circumstances** (such as age, inexperience, or personal problems, each of which may suggest the need for protective limits on the controls that the beneficiary might otherwise be given), **and, often of greatest significance,**

(3) **The outlook of the advisor** (who is helping the grantor or testator create the trust).

IV. <u>FLEXIBILITY IS ESSENTIAL</u>

In the case of any perpetual or dynastic trust, (i) the extended duration of the trust arrangement and (ii) the likelihood that its component trusts will ultimately benefit six or

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[6] Since the issuance of Revenue Ruling 95-58 [following the Tax Court's decision in Wall, 101 TC 300 (1993)], the IRS gave taxpayers reliable assurance as to circumstances under which an independent trustee may be removed and replaced by the trust's settlor or a beneficiary without adverse tax consequences.

more generations (some of which as yet have no living members) magnify the arrangement's exposure to the vicissitudes of time, society, and family evolution. Practically speaking, this means having to deal with:

A. Changes in the tax laws, in investment practices, in state trust laws, and so on, as well as

B. Changes in the family's makeup, including changes in the needs, character, and circumstances of the many present and future trust beneficiaries.

Thus, flexibility is needed to respond to such changes (and to be able to do so without having to undertake a court action for trust reformation every time the need for such a revision in the governing trust document arises). Achieving that kind of flexibility means including in the trust document certain provisions that:

- Permit each separate trust's primary beneficiary to make such changes in the plan as are called for from time to time and

- Empower the trustees to appropriately respond to new and different circumstances.

With long-term trusts, there is always a significant risk that rigidity will produce unintended and inappropriate results in the future – making flexibility essential. However, in the process of developing any mechanisms for making needed changes in the plan, a balance must be struck between providing for maximum flexibility and carrying out the settlor's specific wealth transfer plan in the manner he believed to be most appropriate for his children and their descendants.

A. <u>Powers to make changes held by trust beneficiaries</u>.

A trust beneficiary (usually meaning the primary beneficiary of a separate trust) is normally given three important tools that can be used to adjust the plan for changing circumstances. These are:

1.Special powers of appointment, both exercisable testamentary and inter vivos.
2.Planned for disclaimers, and
3.Powers and rights as to trustee selection- as to both appointment and removal

1. <u>Special powers of appointment-a "rewrite power"</u>

One of the best ways to deal with the prospect of changing circumstances is to give the primary beneficiary of each trust a special power to appoint the trust assets to or among certain individuals, either outright or in a new trust.

a. Necessary restrictions

In order to avoid creating an inadvertent general power of appointment (with consequent loss of the shelter benefits otherwise afforded an inheritance in trust), every special power of appointment should be restricted so that it cannot be exercised in favor of the holder of the power, his or her estate, or the creditors either.

b. Scope of power may be further restricted

The creator of the trust (that is, the settlor or testator, as the case may be) will often wish to further narrow the permissible objects of appointment. For instance –

(1) In many trusts, the beneficiary’s power to appoint will be exercisable only in favor of the settlor’s descendants and the spouses of such descendants- and often, if spouses of descendents are permissible appointees, any appointment to a spouse is required to be made to a trust.

(2) In other trusts, however, the beneficiary’s power of appointment will instead be a “broad” special power (that is, a power exercisable in favor of any person or persons except the holder, his or her estate, and the creditors of either).

(3) Sometimes clients will feel more comfortable if the power to appoint, particularly a broad power, is exercisable by the beneficiary only with a trustee’s prior written approval (as a protection against hasty or rash action and to provide a “reality check” on a proposed exercise). However, such a condition is not consistent with giving full control and the beneficial enjoyment virtually tantamount to outright ownership.

Since the exercise of a special power can always be conditioned on prior trustee (or third party) approval, it would seem that there are very few trust arrangements that should not include at least some kind of special power of appointment – thereby allowing the plan to be rewritten (within specified limits if necessary) effective as of the beneficiary power holder’s death.

B. Powers to make changes held by trustees

A disinterested trustee may be given virtually unlimited discretion to modify most trust provisions without disturbing the tax objectives of the dynastic trust arrangement. With proper protections to assure that the settlor’s dispositive goals will not be modified, an independent trustee may be given powers to cope with tax and/or circumstantial changes and to take advantage of new trust drafting approaches. These powers are of two kinds.

1. **Changing trust provisions by exercise of independent trustee's totally discretionary power to make distributions**

In totally discretionary trusts, the independent trustee's discretion (amounting to a special power of appointment held by the independent trustee in a fiduciary capacity) introduces tremendous flexibility. It permits the independent trustee, by transferring all of the trust assets to a new trust created by that trustee, to, in effect, rewrite the entire trust (as long as it benefits no one other than one or more of the original trust's beneficiaries and permissible distributees).[19]

a. **Limitations on naming new beneficiaries**

The grant of distribution discretion normally limits the making of distributions to a group of permissible distributees identified in the trust document. Thus, the trustee is prohibited from creating a trust which allows a person who is not a listed permissible distributee to benefit. In other words, only a present beneficiary or potential future beneficiary of the trust thus being changed is eligible to be a beneficiary of the new trust to be created by the trustee's discretionary distribution.

b. **Power to distribute to an entity**

The trustee can also be given the power to create any other entity, such as a general or limited partnership, limited liability company, or corporation, provided that such entity is owned and controlled by no one other than such trust and/or one or more of its permissible distributees.

2. **Disinterested trustees' power to amend or restate the entire trust agreement**

Many of our trusts provide that the trustees of each trust that may come into existence under the document, other than any person:

- Who could be financially affected by the amendment involved or
- .Who could be considered to be a donor of any of that trust's assets,

are always given a limited power to amend or restate the entire trust document as it applies to that particular trust (and to all trusts that may arise out of that particular

[19] For an excellent discussion of possibilities which are opened by the grant of a trustee discretion to make distributions to existing or new trusts, see Malcolm A. Moore's 1981 paper at this institute, "New Horizons in the Grant and Exercise of Discretionary Powers" [15 *U Miami Inst on Est Plan*, Ch 6 (1981).]

trust).[20] On the other hand, other clients are uncomfortable permitting a "stranger" to virtually rewrite to trust.

a. <u>Examples of amendment powers typically given to trustees</u>

Illustrative of the kinds of amendment powers routinely given to trustees are the following:

(1) The power to grant or eliminate general powers of appointment – this power can be useful in responding to changes that may be made in applicable transfer taxes, specifically the GST tax.

(2) The power to conform the provisions of any marital deduction trust contained in the trust document to those that are currently required in order to qualify for the marital deduction under the then circumstances – this power is virtually a necessity in the context of a dynasty trust arrangement since it is impossible at the outset to know whether or not some future descendant will be survived by a non citizen spouse.

(3) The power to divide a trust into two or more separate trusts (or subtrusts) – this power can be useful for GST and qualified retirement benefits planning – and also for segregating into a QSST[21] or ESBT[22] shares of an S corporation which may be held in or acquired by any trust contained in the governing trust document.

b. <u>Restrictions on the exercise of the amendment powers</u>

The trustee's power to amend and restate the trust agreement must be restricted for tax purposes so as not to:

(i) Violate the rule against perpetuities,

(ii) Impair any beneficiary's enforceable right to receive income,

(iii) Reduce the restrictions on the grantor's and trustee's actions as set forth in the trust agreement,

(iv) Give a trustee any powers or discretions that would result in adverse transfer tax consequences, or

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[20] See Early, "The Irrevocable Trust That Can Be Amended." 18 *U Miami Inst on Est Plan*, Ch 17 (1984).
[21] A QSST is defined in IRC section 1361 (d).
[22] An EBST is defined in IRC section 1361 (e).

(v) Disqualify any trust which currently qualifies for a deduction, credit, exclusion, or other tax benefit, and,

from a non tax point of view, the power to amend and restate can also be further restricted so that no change can:

(i) Result in any direct or indirect financial benefit (or grant any power of appointment) to any individual who is not at the time of such amendment both a member of the settlors' family (as defined) and already a present or potential future beneficiary,

(ii) Discriminate in any significant financial way in favor of one or more siblings (where siblings are to be treated in s substantially equal fashion), or

(iii) Change any trustee removal provisions, eliminate any requirement that a bank or trust company serve as trustee, lower the age specified in any attainment of a specified age provision, or modify in any way the definition of children, descendants, etc.

c. <u>Trustee exculpation</u>

Since the trustee's exercise of this limited power of amendment or restatement of trust agreement may upset one or more beneficiaries, it is important to include a broad exoneration and indemnification clause.

Exhibit A

The Power of Compound Growth

❑ Assumptions - $1 Million; Trust Lasts 120 Years and Earns 8%; 50% Transfer Tax Every 30 Years

- No Trust - $ 640,812,059
- Dynastic Trust - $ 10,252,992,943

Annual Tax Growth	Value of Trust After 120 Years	Value of Property If No Trust
6%	**$1,088,187,748**	**$68,011,734**
7%	**$3,357,788,383**	**$209,861,774**
8%	**$10,252,992,943**	**$640,812,059**
9%	**$30,987,015,749**	**$1,936,688,484**
10%	**$92,709,068,818**	**$5,794,316,801**