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Estate Planning & Elder Law

Trusts Aren't Just for Taxes, and They Never Were

Preservation of a decedent's wishes provide real value

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Estate planning attorneys assist their clients by recommending the most appropriate ways to achieve wealth transfer goals. A key approach in our planning arsenal is the use of trusts. Although we often think of trusts as a method to minimize transfer taxes, the use of trusts predates our modern estate tax system, such as it is, or will be or may be, given the uncertainty of recent Congressional inaction. Regardless of what happens to the estate tax, trusts provide a powerful and flexible way to address a myriad of nontax concerns. Given the unsettled state of affairs, planners must be especially sensitive to the variety of nontax related situations in which the use of trusts can provide real value to our clients.

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Inheritance by a Surviving Spouse or Significant Other

There are a variety of circumstances when a trust is an appropriate vehicle to hold assets passing to a surviving spouse, civil union partner or unmarried significant other. Even without the estate tax or the related marital deduction, a trust in these situations can address issues of management, protection and control.

The intended beneficiary may not possess the desire, knowledge or capacity to manage the assets he inherits, due to advanced age, assets requiring specialized skills, or other reasons. In such cases, selecting a knowledgeable trustee to select and oversee trust investments (or delegation of that function) will provide competent asset management while providing financial support to the surviving loved one. Use of a trust also can guard against the unintentional or purposeful redirection of assets to unintended third parties. Imagine that a wife dies and leaves all her assets outright to her husband. Although the wife hopes and expects that the husband will leave any unneeded assets to their children at his death, he might — either due to his largesse or by being duped into doing so —give assets to others, leaving the husband without adequate means to support himself and disinheriting their children.

Second marriage and late-in-life relationships often call for use of a trust where a decedent leaves children from his first marriage and wants to provide both for his first marriage's children and his current significant other. A trust can be created to balance the competing interests of the significant other and the children, providing adequate annual cash flow while ensuring that any assets remaining at the second death pass to the children. The trust structure can promote family harmony by minimizing potential friction between the children and the lifetime beneficiary, while also protecting the trustee from charges of favoritism and decreasing the likelihood of expensive litigation. To avoid discord resulting from trust investment decisions (current income versus growth) and trust distributions (cash flow to the lifetime beneficiary versus preserving assets), the trust might be structured as an annuity trust or a unitrust, each of which provides mandatory nondiscretionary cash flow. Additional distributions can also be permitted in the discretion of the trustee. Again, selection of a strong trustee is paramount, since that fiduciary will need to balance the competing interests of the beneficiaries and address potentially difficult emotional issues as the lifetime beneficiary ages.

Younger Beneficiaries

At the opposite end of the spectrum, trusts are also appropriate to provide flexible, competent management of the inheritance of a young or otherwise unsophisticated beneficiary. While frequently used for children and grandchildren, trusts can be used for any beneficiary (i.e., nieces and nephews). The key is structuring the trust to achieve a balance between a beneficiary's eventual access to trust assets and control by the trustee. Age is a relative term here, since some clients may view 25 as an appropriate age for control while others may think 50 is a better choice. Indeed, there may be a difference in the same family depending on which child is the intended beneficiary. Decision points include: (a) the duration of the trust (until the beneficiary attains specified ages, or for the individual's entire lifetime), (b) the purposes for which distributions can be made, (c) whether distributions should be fully within the discretion of the trustee (either subject or not subject to an ascertainable standard), or should be mandated at particular ages or milestones in the beneficiary's life (to reward certain behaviors/achievements), and (d) whether the beneficiary should possess a power to appoint (i.e., direct gifts of) trust assets to others in a specified class, essentially re-writing the terms of the remainder interest.

The selected trustee must be able to judge when distributions are appropriate and how to say "no" when necessary. A particularly powerful provision to consider building into this type of trust is one that permits the trustee to withhold distributions, even if otherwise required at a specific age, if the trustee determines that the beneficiary is not fit to handle funds due to drug use.

Clients may also wish to use the trusteeship as a vehicle for educating a beneficiary about financial management. The beneficiary can become a co-trustee at a certain age with the ability to participate only in trust investment decisions (but not distribution decisions), or to become a full trustee along with one or two others. In this way, the beneficiary can learn how to manage assets alongside a more seasoned trustee before receiving meaningful trust distributions.

Preservation of Family Assets

A trust can be a vehicle to preserve a special family asset for the benefit of multiple beneficiaries and multiple generations. For example, where a client wishes to make a family vacation home available for future use by children and grandchildren over many decades, a trust can provide an efficient structure for managing that asset and its use among various family branches. The particular terms of such a trust must be tailored to address the type of asset to be held, the timing and way in which such assets can be used by trust beneficiaries, the manner in which costs associated with the asset will be funded, and, perhaps most importantly, the selection of one or more trustees to manage the trust. The planner should help the client anticipate potential tensions among the beneficiaries and provide ways for the trustee to address them effectively, including procedures for scheduling use by beneficiaries, whether rental is permitted, identifying the source of resources to cover operating expenses, and when and if the residence should ever be replaced.

Creditor Protection

An appropriately drafted trust can be an effective way to protect assets from the reach of a beneficiary's creditors. The degree of creditor protection afforded by a trust depends on a variety of factors, but generally, greater credit protection is achieved when a trust creates greater "distance" between the trust assets and the beneficiary. It is vital to determine the proper balance between greater creditor protection for the beneficiary and more liberal access to and control over the trust by a beneficiary, since these two goals often conflict with one another.

If the beneficiary can force distributions from a trust, then her creditors may also be able to do so. The key areas of focus are the beneficiary's access to trust assets, the selection of trustees and the application of spendthrift provisions. The greatest creditor protection is achieved where the trustee making distribution decisions is someone other than the trust beneficiary. An independent trustee can be given broad discretion to determine the magnitude and timing of distributions, without entitling the beneficiary to any distributions. The greater a beneficiary's right to obtain trust assets, the lower the degree of creditor protection the trust affords. Thus, the ideal structure is a trust where no distributions are required, but where discretionary distributions by an independent (i.e., a non-beneficiary) trustee are permitted.

If drafted carefully, a trust can permit the beneficiary to serve as trustee, but doing so requires imposition of certain limitations on the beneficiary-trustee's authority and may open the door for attacks by a creditor. Although a beneficiary-trustee should not be given unfettered discretionary distribution authority in favor of himself, a beneficiary could serve as a co-trustee of a trust for his benefit with authority to participate only in investment decisions, or as a trustee able to make distributions to himself subject to tightly drawn standards.

Certainly, all such trusts should incorporate spendthrift provisions designed to prevent a trust beneficiary from assigning or anticipating his interest in the trust, since the absence of such a provision may allow a beneficiary's creditors to force an assignment of the beneficiary's rights in the trust. An outright inheritance of assets may also jeopardize the qualification of a beneficiary with special needs for public assistance programs and benefits. While this issue is too technical to address in this article, clients are well-advised to consult with an attorney who specializes in elder care and special needs trusts.

Even in situations where tax minimization strategies are not necessary, trust planning can provide meaningful benefits to clients and their intended beneficiaries. As planners, we must be well-versed in the many ways that incorporation of trusts can help to achieve a client's goals, and think creatively about the proper structuring of trusts to address the particular goals of our clients and situations faced by their beneficiaries. ■