The Trust Walk

Walking Down the Path of Various Types of Trusts and Avoiding Hot Coals at the Same Time

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As a tax or financial professional, it is important to be well equipped to help your client navigate the often complicated and murky waters of estate planning. The larger the estate at issue, the more questions may arise. How do I avoid estate tax? Will my loved ones be burdened by capital gains tax? How can I make things as streamlined as possible for my family once I am gone?

These materials seek to give you a foundation to begin to answer these questions. It provides a framework for different estate planning tools, with a focus on trusts. The goal of these materials is to give you, the tax or financial professional, the tools with which to help your clients down the wandering path of The Trust Walk.

I. Which is right for your client: a will or a revocable trust?

> Your client, Dorothy, wishes to meet and discuss estate planning issues. She amassed a fortune after selling her farm in Kansas to real-estate developers in 2006. She wants to make sure her closest friends, Scarecrow, Lion, and Tin Man are provided for after she dies. She has concerns, however, that Scarecrow may not know what to do with all that money at once, and she wants to make things as easy as possible for her friends after she dies. Would you recommend a will or a trust as Dorothy's primary estate planning tool?

Generally speaking, a will serves as a guide to streamline the transfer of assets to beneficiaries through probate after the client's death, while a revocable trust is akin to a separate legal entity, such as a corporation, that a client establishes during his or her lifetime in order to avoid probate.

A. Wills –The Difference is Probate

- A will requires a probate procedure for singly-owned assets upon death.
- Probate involves the judicial system, at some level, overseeing the orderly transfer of assets at death.
- A will streamlines the probate procedure by providing information regarding the intended beneficiaries as well as administrative preferences, such as who shall serve as the personal representative of the estate.

B. Revocable Trusts

- The person creating the trust, known as the grantor, creates the trust document by an agreement with a trustee, who has control over the assets owned in the name of the trust.
- Real estate and non-qualified assets (such as savings accounts, certificates of deposit, and bonds) are transferred into ownership by the trust.
- Because the trust is *revocable*, it can be modified and trust assets moved in and out throughout the grantor's lifetime.
- Typically, at the time of the grantor's death, the trust becomes *irrevocable*, and trust assets are distributed to beneficiaries by the trustee without the need for probate.

C. Either Instrument–Control over Distributions

A client can achieve the same amount of control over how his or her assets are distributed after death with either a will or a revocable trust.

- By including a testamentary trust provision in a will, which creates an irrevocable trust at the time of the client's death, distributions to beneficiaries can be structured over time the same as with a revocable trust created during the client's life.
- Distributions from either instrument could be made every year for 10-15 years or at specified ages (e.g., 25, 30, 35, etc…), perhaps on the beneficiary's birthday or the anniversary of the decedent's death. Distributions could also be made to incentivize behavior; for example, a distribution upon earning a degree or distributions in an amount that varies according to the beneficiary's income (e.g., 50 cents to every dollar earned).
- Typically, a discretionary distribution provision is included, which allows for unscheduled distributions for expenses pertaining to health, education, support and maintenance, as well as expenses related to life events, such as buying a car or starting a business.
- Either a revocable trust or a testamentary trust provision in a will could shield assets from a beneficiary's creditors or from becoming marital property until they are distributed, which can be desirable for clients with large estates.

D. Factors to Consider

Five main factors should be considered when determining whether a will or a revocable trust is the right primary estate planning document for your client.

1. **Asset Accumulation vs. Asset Administration.** A person in the asset accumulation phase of life may be younger, with growing assets that may evolve into a more diverse estate in the future. This may not be the last estate planning document they create. A will may be more appropriate for this client. For a client in the asset administration phase of life, who may be approaching or in retirement and ready to prepare their final major substantive rewrite of their estate plan, a revocable trust may be the better option.

2. **Nature and Extent of Assets.** A client with assets such as real estate, life insurance, retirement accounts, non-qualified assets, and other assets that can be structured to avoid probate on their own (without a probate-avoiding instrument like a revocable trust) may benefit from a will as a safety net for any assets that end up in probate. On the other hand, a client with a more diverse profile of assets—qualified and non-qualified assets, promissory notes for loans to family members, real estate in multiple states—would do well to establish a revocable living trust.

3. **Simplicity/Complexity of Estate Plan.** For clients with a relatively straightforward estate plan, a will may be a fine option. Other clients may have more complex estate plans, perhaps providing specific assets to specific persons or establishing a series of testamentary trusts. For these clients, it would be wise to establish a revocable living trust.

4. **Married Couple—Taxable Estate.** If a married couple has an estate well in excess of the state or federal estate tax exclusion amounts, it may be wise to split assets between the two spouses and adopt what are known as A-B testamentary trusts, or disclaimer trusts. This type of trust allows each spouse to take advantage of their full estate tax exemption by leaving their assets to a revocable trust, from which the surviving spouse receives income. This prevents the assets of the first spouse to die from transferring to the surviving spouse and increasing their taxable estate. Although this can be accomplished with a will, establishing a revocable living trust will avoid probate and streamline the process for your client's family.

5. **Confidentiality and Contesting the Estate Plan.** Clients with confidentiality concerns may opt for a revocable trust over a will. A will requires assets to pass through probate, which is a public court procedure. As such, anyone could obtain access to the court file, which may reveal information about assets and distribution. Avoiding probate with a revocable trust can keep that information confidential to protect not only the client, but also the beneficiaries.

E. How to Choose a Trustee

If your client chooses to establish a revocable trust, a will with a testamentary trust provision, or any other type of trust, they will have to choose a trustee. As the person selected will eventually take charge of all the trust assets, choosing who will serve as trustee is one of the most important decisions the client will make.

- Many people choose a trusted, responsible family member to administer their trusts. This option can work well for simple living trusts that will not take long to fully administer and do not contain a large amount of assets.
- A corporate trustee such as a bank or financial services firm may be a good option for clients with a large estate and a trust that is intended to last a long time, or clients that fear family conflict. The downside of a corporate trustee is the administration may be less personal and more expensive.
- Regardless of whether your client chooses a trusted individual or an organization to serve as trustee, the trustee selected should be trusted, organized, and responsible. It also helps if the trustee has experience dealing with tax and financial issues or is able to seek out the help of a professional when necessary.

II. Irrevocable Trusts

Your client, Lorelei Lee, inherited an enormous fortune from her late husband Gus (as well as an extensive collection of diamonds, her best friend). She wants to make sure her children, as well as her other best friend, Dorothy Shaw, are able to enjoy her fortune well after she is gone. She is concerned, however, that much of the estate will fall victim to enormous estate tax rates. What tools will you recommend to protect her assets?

If your client's estate exceeds the Minnesota estate tax exemption of $1,600,000 (in 2016, rising to $2,000,000 in 2018), or the federal estate tax exemption of $5,450,000 (in 2016), additional tools such as an irrevocable trust may help protect those assets from taxes while still meeting the client's goals of providing for their loved ones.

A. About Irrevocable Trusts

- Irrevocable trusts are generally created during the client's lifetime. After creation, they cannot be modified, and any assets transferred to the name of the trust no longer belong to the grantor.
- Once the assets are transferred to the name of the trust they are no longer part of the grantor's taxable estate.
- Although the client will not be able to directly access the trust's assets, they can choose to be paid any income from the trust during their lifetime.

B. What to Put in an Irrevocable Trust

- Transfer assets the client does not need; after the assets are in the name of the trust, the client will not be able to transfer them out.
- Examples include money to pay for estate taxes, life insurance policies, and "second-to-die" insurance policies.
- Investments can also be transferred into the irrevocable trust's name to ensure that their income and growth is outside of the taxable estate.
- Because the property will not enjoy a step-up in basis, transferring real property into an irrevocable trust is best where the client intends for the property, such as a family cabin, to stay in the family for generations, or where the property is income-generating so as to be exchangeable in what is known as a 1031 like-kind exchange.

III. Family Limited Partnerships

A family limited partnership (FLP), while a business entity rather than a trust, is another tool available to your clients to manage their wealth and its distribution.

A. Structure of an FLP

- Partners are either General Partners or Limited Partners. Often your client (and perhaps another person) will serve as General Partner, and children or other relatives are named Limited Partners.

- If an FLP were a train, the General Partner would be the engine, and the Limited Partners would be the boxcars. The "engine," or General Partner, controls and directs the FLP's operations. The "boxcars," or Limited Partners, on the other hand, are part of the train but have no control.

B. Advantages and Disadvantages of an FLP

- A major advantage of the FLP is that the family members with a limited interest have a stake in the outcome and can feel involved in the FLP's operations even though they do not have any direct authority or control.
- Because the limited partnership interest lacks control it has limited marketability. Who would buy just one boxcar without an engine? Thus, FLP partnerships stay within the family.
- Although grants of limited partnerships are taxed as gifts, their value is discounted based on the limited partnerships' level of control and marketability. Generally, the less control and less degree of liquidity, and thus marketability, a limited partnership grants, the higher the discount.
- Keep in mind that any units granted from the FLP do not enjoy a step-up in basis for capital gains purposes. Any income generating property, however, could be exchanged in a 1031 like-kind exchange.

IV. GRATs, GRUTs, CRATs, and CRUTs!

> Lucy and Ricky are your long-time clients. They wish to meet with you to discuss some estate planning issues. Specifically, they want to know how best to handle about $3 million in securities they hold. Their goals are to eventually transfer the wealth to their son Little Ricky while avoiding hefty gift and estate taxes. They are a bit nervous to simply part with the assets, however, and would like to enjoy the income those securities will generate in the years to come.

GRATs (Grantor Retained Annuity Trusts) and GRUTs (Grantor Retained Unitrusts) are types of irrevocable trusts. The client creates the trust during their lifetime for a fixed period of time. The client, as grantor, receives an annual income from the trust. After the time period for the trust expires, the assets pass to the beneficiaries. CRATs (Charitable Remainder Annuity Trusts) and CRUTs (Charitable Remainder Unitrusts) are the same as GRATS and GRUTS except a charitable organization is the beneficiary.

A. *Difference between GRATs, GRUTs, CRATs, and CRUTs*

- With a GRAT, the grantor's income is set as a fixed dollar amount.
- With a GRUT, the grantor's income interest is a fixed percentage of the value of the trust, as it is valued each year. The grantor's income interest can grow each year with a GRUT.
- GRATS are more popular because the growing income interest of the GRUT can defeat the primary objective; that is, to transfer the largest amount to beneficiaries with the lowest possible tax consequences.
- With a CRAT or a CRUT, the client can give a gift, get some back in income, and take a further deduction each year for the amount the charitable organization retains.

B. *Advantages and Disadvantages*

- Because these trusts are irrevocable, when they are created and assets transferred to the name of the trust it is considered a gift to the beneficiaries, subject to tax.
- The taxable value, however, is reduced to reflect the value of the income interest retained by the grantor. The longer the trust lasts and the higher the income interest retained by the grantor at the trust's creation, the lower the taxable value of the gift will be.
- The grantor loses all control over the assets, including control over buy/sell decisions.
- If the donor dies before the time period for the trust has run, the full value of the trust's assets will be included in the donor's taxable estate.

V. Donor Advised Funds

A Donor Advised Fund is a philanthropic vehicle established at a public nonprofit organization. It allows your clients to make irrevocable transfers to their fund account, providing them with the immediate tax benefits of charitable gifting. The client is then able to advise the fund as to which non-profit organizations they wish to recommend grants. Although the client does not technically have control over which organizations receive grants from their fund, Donor Advised Funds usually follow client recommendations to the fullest extent possible.

- Creating a Donor Advised Fund can involve the entire family and teach children to be philanthropists. It is also a great talking point that opens doors at cocktail parties!

- Gifts of marketable securities to the fund help avoid capital gains taxes and are fully deductible. As such, the client can contribute to the fund when the tax benefits are convenient and decide later on to which charities they would like to recommend grants.

- Donor Advised Funds provide many of the desirable benefits of a private foundation with lower operating expenses, simplified administration, and the option of anonymity.

VI. Qualified Personal Residence Trusts (QPRTs)

- A QPRT is an irrevocable trust with a specified term of years (usually 10-20). A personal residence (primary or secondary) is transferred into the name of the QPRT. The grantor retains the right to live in the property rent-free for the trust term.

- After the trust term expires, the residence passes to the trust's beneficiaries. The grantor can then continue to live in the residence and pay rent to the beneficiaries as an additional way to transfer money without tax consequences.

- The beneficiaries will inherit the tax basis of the residence for capital gains tax purposes. This is an attractive consequence for some clients because it can dissuade the beneficiaries from selling the property.

- QPRTs are only a good idea for clients who do not expect to die within the trust term. If the grantor dies before the trust term is up, the residence in the QPRT will become part of the grantor's taxable estate.