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Jonathan G. Blattmachr
 Editor-in-Chief

InterActive Legal Systems

Corporate Headquarters
 100 Highland Park Village
 Suite 200
 Dallas, TX 75205

Michael L. Graham
 President & CEO

Patricia A. McLelland
 Chief Operating Officer

Sales & Support
 (888) 315-0872
sales@ILSDocs.com
support@ILSDocs.com

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Putting It in Trust: Perhaps the Most Important Decision of All

By [Jonathan G. Blattmachr](#) and [Michael L. Graham](#)

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Introduction

Our mothers taught us that while it is very easy to get toothpaste out of a tube, it is nearly impossible to get it back in. Accordingly, you want to start with as much in the tube as possible. The same is true of property: it is very easy to transfer assets out of a trust but nearly impossible to transfer them back into a trust that offers all the tax, management, administration, and creditor protection benefits of a trust. Although it is very common to transfer property to one's loved ones outright, it likely will be preferable for property to remain in trust for as long as the law allows.

Disabilities of Beneficiaries

Few, if any, attorneys would fail to recommend that a client put his or her assets in trust for a family member who is under a legal disability, such as being a minor or being incompetent. Giving or bequeathing assets outright to a minor or an incompetent is a recipe for disaster resulting in maximizing court interference with the management of the property, reducing flexibility in using the property for the benefit of the person for whom it was set aside, and increasing the attorneys' fees relating to the transmission, management, and expenditure of the property.

Change the facts slightly, however, to a case where a client wishes to leave property to a grown daughter. At present the daughter is 50 years old and legally competent, but what if she were diagnosed with Alzheimer's Disease for example? Certainly almost all attorneys would recommend placing the assets in trust for the daughter as the probability of her becoming legally incompetent relatively soon is quite high. Most attorneys do not seem to appreciate that the immediacy of a beneficiary becoming incapacitated is not the key in issuing a trust. In fact, the ravages of age continue to be so severe that for the foreseeable future, a high percentage of individuals will suffer substantial difficulty in managing financial affairs prior to death. The 50-year-old daughter in the example, even if completely healthy today, very likely will someday be in a nursing home, not only unable to write checks but incapable of understanding what options are available for the management of her property.

Of course, there are things the daughter could do later in her life to protect against certain adverse effects of disability and subsequent incapacity to manage assets. She could create a revocable trust, execute a power of attorney, or take other steps. However, if she is like most people, she will do none of these. Therefore, it makes sense to start with a trust for virtually any transfers for beneficiaries.

PROTECTION FROM CLAIMS

In many ways a trust's greatest attribute is its ability to protect assets against claims—not just claims of creditors, which will be discussed later in this article, but claims or demands by others to the property. The 50 year-old daughter in the example may someday be subject to unwise, unfair, and unreasonable demands that she cannot resist. Those demands may come from financial charlatans,

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unethical lawyers, or unbalanced accountants, but they also may arise from friends, relatives, or someone else looking to take advantage of her. As is well known, older individuals are more prone to financial scams than are younger people and because most everyone ultimately becomes a senior citizen, the chance of becoming a scam victim increases.

Trusts help to protect against that occurring, at least when there is a trustee other than the beneficiary. If a client is living in a nursing home and someone were to suggest that funds should be invested in land on Mars, an independent trustee likely would decline that investment opportunity even if the beneficiary, who may or may not be a cotrustee, desperately wanted to so invest.

Marriage represents another situation in which individuals are often subject to unwise demands or suggestions. When a spouse wants something, such as money to be invested in his or her business, it becomes almost impossible for the spouse holding the money to refuse. However, if the assets are in a trust where the investment can be made only with the consent of a trustee other than the spouse, the investment demand by the other spouse may be declined by the independent trustee, and the assets are more likely to be preserved.

In most jurisdictions property received by gift, bequest, or inheritance (sometimes called "separate property") is not subject to award to the "other" spouse upon a divorce. Typically, the person claiming that exemption must prove the separate "pedigree" nature of the property. However, particularly in long-term marriages, separate property often becomes mixed with marital property. Therefore, what one spouse may consider his or her "non-marital property" may, in fact, still be subject to division between the spouses by the courts upon divorce. Also, in some states, such as Connecticut and Massachusetts, property received by gift, bequest, or inheritance is subject to division in a divorce. A somewhat similar situation exists in Colorado, and the trend seems to be growing among the states.

Conversely, a properly constructed trust is almost never subject to division by a court (although in some jurisdictions income received or receivable by a divorced spouse may be used by the courts to fund alimony and/or child support). With about 50 percent of American marriages ending in divorce, it seems appropriate to consider a trust for any beneficiary who might be married at some period in time.

From a historic standpoint, trusts have been especially effective in protecting assets from claims of creditors. A judgment can usually be enforced against any property owned by the defendant (subject to minor exceptions). Yet the United States Bankruptcy Code provides an exemption for interest in trusts to the extent governing state law protects trusts from claims. In most states a trust created for a beneficiary by someone else, such as by one spouse for the other or by a parent for a child, may be entirely immunized from claims of such creditors. Thus, it makes sense to provide for the property to be placed in trust for beneficiaries.

TAX REDUCTION

When it comes to tax reduction, a trust outshines virtually every other type of arrangement. For instance, a trust usually can provide for its income to be paid among a class of beneficiaries. The trustee, for example, in such a case, may distribute that income to the beneficiaries who are in the lowest income tax brackets, either because their other income places them below the threshold at which the maximum federal tax rate occurs or because the beneficiaries reside in state or locations where there are no (or relatively low) income taxes.

In fact by accumulating income, trusts frequently can be structured to avoid state and local taxes that would be imposed upon beneficiaries if the income were received. Several states, including Alaska and Florida, have no state income taxes. Even some states such as New York that have income taxes provide an exemption for a trust administered in their state provided the person who created the trust did not reside there when the trust was created. By accumulating the income in such a trust and distributing it at a later time to beneficiaries, it is often possible to avoid most of the state and local income tax that beneficiaries otherwise would face.

Although a generation-skipping transfer (GST) tax is imposed when property is transferred from one generation to the next, that tax may be avoided to the extent that the property owner's GST exemption (\$2,000,000 for calendar year 2006) is allocated to the trust. When the trust is protected from tax by the allocation of that exemption, it is protected from the tax regardless of how long the trust lasts and regardless of how large the trust becomes. Over a term of 120 years (which is about the maximum length of time a trust can last under the laws of most states, whether or not one uses the exemption by applying it to a long-term trust) can make a difference of several times the amount which is available for family members at the end of the trust—24 times! The only way to gain that tremendous advantage is by putting assets in trust.

Even for the balance of a taxpayer's property that cannot be protected from GST tax by allocation of the GST exemption (because it is

used elsewhere, such as for other trusts), long-term trusts can save estate, gift, and GST taxes compared to transferring property outside of a trust. This is because the property is not subject to GST tax if it is instead subject to estate or gift taxes.

On the other side, there are several differences between estate and gift tax. In certain circumstances one tax may be preferable to another. Keeping the property in trust is the only way to be able to choose.

STRUCTURING TRUSTS

The Internal Revenue Code sometimes prescribes the form a trust must take in order to achieve a certain tax result. For instance, most trusts that qualify for the estate or gift tax marital deduction must provide that the income be paid to the beneficiary spouse at least once a year and that the spouse must have the absolute right to force the trustee to make the trust productive of a reasonable amount of income.

Most trusts, however, do not have to be in a certain form in order to achieve the beneficial results described above. In fact, a trust providing no specific benefits to beneficiaries probably is the best of all: It provides the greatest opportunity for safeguarding the property and minimizing taxes with respect to the assets.

However, the question of how the individuals will benefit from the trust naturally arises. Benefits are bestowed through the exercise of discretion by the trustees. Often it is best for the property owner who creates the trust to provide the trustees with guidance to what he or she wishes to accomplish for the beneficiaries. Even a suggestion like "it is my hope and expectation, if not my direction, that the trustee will pay my daughter \$1,000 each month (adjusted for inflation)" is the kind of guidance almost all trustees will follow.

Experience indicates that corporate fiduciaries (such as banks and trust companies) readily welcome such guidance and, unless it would cause an adverse effect, almost certainly will follow it. Further guidance may include a statement of expectation that trust funds will be used to pay for education, to provide funding to start a business, and/or to make investments the trustee would not otherwise feel comfortable in doing (for example, those that are more speculative than a trustee would normally make).

Trusts also can be used to try to enhance "good" behavior and/or discourage "bad" behavior by beneficiaries. For instance, the grantor might provide that he or she prefers that the beneficiary receive no distributions except for education until the beneficiary graduates from an accredited college or it is determined that some factor, such as a disability, prevents him or her from doing so. Alternatively, the trust might allow a beneficiary to appoint an amount of trust corpus to charity equal to what the beneficiary personally has donated to it.

USE TRUSTS

In addition to permitting the trustees to make distributions to the beneficiaries, there is another way to provide benefits and continue to preserve the protective nature of the trust. Authorize and encourage the trustees to acquire assets for the use of the beneficiaries.

Although it is not widely known, the law appears to be relatively well settled. The rent-free use by the beneficiary of property owned by a trust does not result in imputed income to either the trust or the beneficiary. Acquiring assets such as a home, recreational property, or works of art for beneficiaries and allowing the beneficiaries to use them for free means the assets continue to be owned by the trust. As such they are not subject to claims arising in the event of divorce or bankruptcy, and generation-skipping transfer and income taxes are minimized. In some ways, therefore, a trust can be used to allow beneficiaries to live like millionaires but not have to face the potential adverse effects of being millionaires.

WHEN THE BENEFICIARY DIES

Trusts may be structured so the beneficiary may specify by his or her will where the property passes when the beneficiary dies. The class of persons to whom the beneficiary may appoint the property could be quite narrow, such as only among the grantor's descendants, or quite broad, such as anyone other than those entities (the beneficiary's own estate) which would cause the trust to be taxed as part of the beneficiary's estate. If some limitation on the exercise of such a power of appointment is desired, the power may be specified to be exercisable only with the consent of an independent trustee. In fact, if carefully structured, the power can be exercised by the beneficiary to cause the property to be subject to estate tax rather than GST tax when the beneficiary dies. In many

cases, estate tax will be lower than GST tax.

HOW LONG SHOULD IT LAST?

Most jurisdictions limit how long a trust may last by what is known as the "rule against perpetuities," which may, in effect, be as long as 120 years. Further, many states, including Alaska, Delaware, and South Dakota, permit trusts to last essentially forever. Although 120 years may seem like a sufficiently long time, the trust may end at a most inappropriate time, such as while the beneficiary is being threatened by a judgment creditor. Allowing the trust to last as long as the trustee decides means that the trustee may end it in whole or in part at the "right" time rather than have it end at a random time.

WHO SHOULD BE TRUSTEE?

Beneficiaries may, and often should, serve as trustees holding certain duties such as to make or participate in investment decisions. Beneficiaries, however, should not be permitted to participate in decisions to pay themselves income or principal—such a power may cause tax and/or creditor claims problems.

In any case, some person or institution needs to be the independent (non-beneficiary) trustee or trustee. Frequently, someone or some entity will be the clear choice. However, many times this is a perplexing decision for the property owner. Even if one individual is the ideal choice now, that person probably will not serve as long as the trust lasts. Therefore, the difficult issue of selecting a successor arises.

Experience indicates that the trust should build in a system of "checks and balances" just as the U.S. Constitution does. The trust may be structured in several ways. One way allows a group of independent persons, typically called "trust protectors", to remove and replace trustees for a stated cause or for any cause, but does not permit the trust protectors to appoint themselves or persons or institutions "close" to them. It may be appropriate to allow the beneficiaries, either for cause or at stated intervals, such as once every five years, to removed the trust protectors and appoint other independent persons to take over the trust protector position.

THE BOTTOM LINE

Some individuals will claim that trusts are an invention of lawyers to keep heirs from receiving the property to which they are rightfully entitled. That claim is wrong for two reasons: First, there is no entitlement to an inheritance as a general rule and second, trusts are not used to deny the beneficiaries benefits. Rather, trusts, if properly structured and administered, are employed to make sure the benefits will always be there.

* This article is derived, in part, from other writings of one or both authors.

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