# Estate Planning Insights

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## LET'S DISCUSS TRUSTS-PART TWO

**Continuation Of Our Trust Discussion.** In the first newsletter in this series (dated April 30, 2017), we began discussing trusts. In our April newsletter, we explained the basics of trusts, including the parties to a trust, how trusts can be created, the difference between revocable and irrevocable trusts, why "Bypass Trusts" became standard estate planning devices, and other matters. In this newsletter, we will continue our discussion of trusts. We now realize that we will need to continue with our discussion of trusts and have a "Part Three" as well.

**Revocable Trusts.** Revocable trusts are created primarily for two reasons: (i) to avoid the probate process at death (whether one is trying to avoid Texas probate or ancillary probate in another state where the person owns real property) and (ii) to avoid a guardianship during life in the case of loss of mental capacity. A "fully funded" revocable trust will avoid the probate process at death. [As we have noted in many prior newsletters, however, just because the probate process is avoided if you die with a fully funded revocable trust does not mean that *nothing* has to be done when you die. There are 3 parts to the "post-death process" and probate is just the first of those 3 parts. We have also noted that the probate process in Texas is very easy.]

In addition, a *fully funded* revocable trust is a better long-term asset management vehicle than a durable power of attorney. In fact, in recent newsletters we have noted some of the problems that have been coming up in regard to durable powers of attorney (mostly having to do with the "policies" of certain financial institutions). However, a lot of time and expense may be incurred to "fully fund" (put all assets into) a revocable trust before death or incapacity, and many people do not follow through with that part of the process. That is why a person who creates a revocable trust must still have a Will and a durable power of attorney.

A person who creates a revocable trust should have a "pour-over Will" so that any assets that were not placed in his trust prior to his death will be "poured into the trust" upon his death. Of course, the pour-over Will must be probated to be effective. Therefore, probate is not avoided in a case in which "probate assets" were not held in the trust prior to death.

A person who creates a revocable trust still needs a durable power of attorney ("POA"). If the creator of a revocable trust loses her mental capacity prior to placing all of her assets into her trust, her financial agent under her POA can retitle those assets not already held in the trust into the name of the trust. In addition, there are some assets that cannot be titled in the name of a revocable trust while the person is still alive. Two examples are employee benefit plans and IRAs. Thus, even though a person may have a revocable trust, he will still need a POA so that investment decisions (for example) with respect to his IRA can be made by his financial agent during the time when he is incapacitated.

There are some other reasons for creating revocable trusts, but we are going to focus primarily on *irrevocable* trusts in this newsletter.

**Some Potential Benefits Of <u>Irrevocable</u> Trusts.** In the case of certain types of *irrevocable* trusts, the following benefits (among others) are possible to achieve *for the beneficiaries of the trust*:

1. Creditor Protection.
2. Guardianship Avoidance.
3. Estate Tax Avoidance.
4. Increased Income Tax Options.

We are *not* going to discuss "self-settled" irrevocable trusts in this newsletter. A self-settled irrevocable trust is an irrevocable trust that a person creates for the benefit of himself. Self-settled irrevocable trusts do not work under Texas law to provide most of the benefits noted

above. Thus, in this newsletter, we will be discussing *irrevocable trusts that one person creates for the benefit of another person*.

There are many types of irrevocable trusts that one person might create for the benefit of another person (or for a group of persons). Typical examples are Bypass Trusts and Marital Trusts created by one spouse for the benefit of the other spouse and Child's Trusts and Descendant's Trusts created by a parent or grandparent for children and grandchildren. There are also some "very specialized" irrevocable trusts. For example, a "Special Needs Trust" can be created for a person who is disabled and receives government benefits, to provide additional enjoyment to that person without causing him to lose his government benefits.

**Creditor Protection.** There are many types of "creditors." Examples include a tort creditor suing for personal injuries sustained in a car accident, a spouse suing for a divorce, a contract creditor suing due to a breach of contract, a person suing a professional for malpractice, a bankruptcy trustee, and children of a deceased spouse in a second marriage situation where the couple in the second marriage failed to obtain a marital property agreement defining the ownership of their assets. If a creditor obtains a judgment against you as a result of a lawsuit, that creditor will try to obtain satisfaction of his judgment. If you have any type of insurance that will pay all or a portion of that judgment, that's great, but not all creditors' claims can be insured against (or the insurance proceeds might be less than the amount of the judgment). Thus, the creditor will usually try to take assets that you own to satisfy his judgment.

Some assets that people own are "exempt" from creditors' claims due to either state or federal law. Examples of exempt assets include (i) your homestead (due to the Texas homestead laws), (ii) your qualified employee benefit plan (due to ERISA), (iii) your IRAs (due to a specific Texas statute), and (iv) a certain amount of family and personal assets, such as home furnishings, food, family heirlooms, the family Bible, vehicles, farm equipment, machinery and animals, etc. Other assets you own do not have any exemption from creditors' claims, such as your "after-tax" bank accounts, brokerage accounts and investments (stocks, bonds, mutual funds, etc.). By saying, "after-tax," we are excluding cash and investments *inside* your qualified employee benefit plan and IRA.

A Will or Trust Agreement that creates irrevocable trusts should contain a "spendthrift trust" clause. It is the *spendthrift trust* clause that protects the assets held in the trust from being taken by a creditor to satisfy his claim or judgment against the beneficiary of the trust. Of course, if cash or other assets that were previously held in the trust are distributed out of the trust to the beneficiary, those assets will no longer be covered by the spendthrift trust clause. The spendthrift trust clause only protects the assets still held inside the trust. Thus, if a beneficiary of a trust has existing creditors, the Trustee should be careful when it comes to making distributions from the trust. In that case, instead of making distributions directly to the beneficiary, the Trustee should make distributions "for the benefit of" the beneficiary. For example, the Trustee could pay the beneficiary's college tuition, room and board and other charges that appear on the college's invoice directly to the college.

Note that the Trustee of the trust cannot thwart creditors' claims by refusing to make distributions out of the trust that are *required* to be made or that the beneficiary has an absolute right to obtain. Whatever the beneficiary is absolutely entitled to receive from the trust, the creditor of the beneficiary can reach. Thus, in terms of creditor protection, it is usually better to create trusts (i) that last for the beneficiary's entire lifetime and (ii) that give the Trustee *discretion* regarding the making of distributions from the trust to the beneficiary. For example, if the beneficiary's trust terminates when he reaches age 35, that means that all of the trust assets will be distributed outright and free of trust to the beneficiary once he reaches age 35. Thus, those assets will no longer be protected by the spendthrift trust clause. Or, if the trust instrument gives the beneficiary the right to withdraw a certain amount at a certain age and that right does not expire, even if the beneficiary fails to exercise her withdrawal right, the creditor of the beneficiary can obtain from the trust whatever the beneficiary was entitled to withdraw. Further, if the trust provides that *all* of the trust's income must be distributed out of the trust to the beneficiary each year, the beneficiary's creditor can obtain that income.

The most common "creditor" is a spouse suing for a divorce. In a divorce, each spouse may claim that certain assets are that spouse's "separate property." *Separate property* is very precisely defined under Texas law. It means a lot more than having an asset titled in your sole name. [In Texas, all we can really tell from the title of an asset is the manager of the asset–not the owner. In fact, we have sole management community property in Texas–assets titled in one spouse's name that are still community property.] The reason divorcing spouses want to claim that certain assets are their separate property is

because the divorce judge cannot award any part of one spouse's separate property to the other spouse in a divorce.

As everyone knows, Texas is a community property state. We have a presumption in Texas that all assets on hand when a marriage terminates (whether by death or divorce) are community property. To rebut the community property presumption, the spouse who is claiming that a particular asset is her separate property must prove it by clear and convincing evidence. That is the highest burden of proof in Texas civil law.

In addition, Texas has a rule that often causes community property to become "commingled" with separate property. *Commingling* can cause assets that once were separate property to lose their status as separate property, in whole or in part. In Texas, ALL income during the marriage, *including income earned by separate property assets*, is community property. Thus, merely opening an account titled in your sole name and labeling the account your separate property and placing in that account the assets you owned prior to the marriage and/or the assets you received by gift or inheritance is not sufficient. That is because those assets are going to earn income during the marriage and that income is going to be community property. Thus, if you reinvest dividends or use income earned by the assets in the account to purchase new investments, the account will be "commingled." It will contain both separate property and community property. Over time, the account may become so commingled that you will not be able to prove, by clear and convincing evidence, what portion of the account was–and still is–your separate property.

In the case of an irrevocable trust created and funded by one person for the benefit of another person that has been properly administered, if the beneficiary and her spouse are getting divorced, the beneficiary's spouse cannot claim that any of the assets held in the trust are community property. In fact, that divorcing spouse cannot even claim that income that was earned by the trust assets and properly retained in the trust is community property. In the case of an irrevocable trust, the assets inside the trust are "trust assets" and the income retained by the trust is "trust income." Neither is community property. Thus, under Texas law, irrevocable trusts provide divorce protection for the trust assets. This is why parents and grandparents often create estate plans in which the inherited assets passing to their children and grandchildren will be held in lifetime irrevocable trusts, such as a Child's Trust or Descendant's Trust. The divorce rate is high and the risk of divorce does not go away once the child or grandchild reaches a certain age, like 25 or 30. Thus, "Contingent Trusts" that terminate at a certain age only provide divorce and creditor protection until that age is reached. Once a Contingent Trust terminates, the assets are owned outright by the individual and are no longer protected.

**Guardianship Avoidance.** People are living longer and many people eventually lose their mental capacity. One study indicates that, upon reaching age 85, the risk of Alzheimer's disease is 50%. If the mentally incapacitated person's assets are not held in some sort of trust, her assets *could* end up in a legal guardianship. Guardianships are court-supervised, "public" proceedings that are expensive, time-consuming, cumbersome and demeaning.

We mentioned earlier that a fully funded revocable trust can avoid a guardianship. The problem is that many revocable trusts are not fully funded at the time when the person loses her mental capacity. If someone in the family wants to obtain a guardianship over the mentally incapacitated person and her assets, that guardian, if appointed, can stop the POA agent from putting the incapacitated person's assets into her revocable trust. Thus, an unfunded revocable trust is not necessarily going to avoid a guardianship.

In contrast, if one person creates and funds an *irrevocable* trust for the benefit of another person (or assets go into an irrevocable trust on the trust settlor's death), that irrevocable trust is going to avoid a guardianship over the assets held in the trust. (Of course, that irrevocable trust will not avoid a guardianship over the incapacitated person, herself, or her assets outside the trust.) Thus, in the case of a trust that will last for the beneficiary's entire lifetime, the possibility of that beneficiary losing her mental capacity in the future means that placing assets into an *irrevocable* trust for that person is a good idea.

**Estate Tax Avoidance.** In our prior newsletter, we discussed, in some detail, how a Bypass Trust (an irrevocable trust created on the death of the first spouse for the primary benefit of the surviving spouse) can avoid estate taxes on the death of the surviving spouse. It is not unusual in the case of an irrevocable trust created and funded by one person for the benefit of another person to be able to keep the trust assets out of the beneficiary's "gross estate" for federal estate tax purposes when the beneficiary dies, thus avoiding estate taxes on the remaining trust assets upon the beneficiary's death. That is possible even though the trust assets are available to the beneficiary for her entire life. Further, that is possible even if the beneficiary is the Trustee of her own trust,

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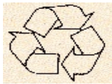

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although the trust distribution provisions must be more narrowly drafted to achieve that result in that case. On the other hand, it is fairly easy to keep trust assets from being included in the beneficiary's estate at death when the trust is designed so that only an "Independent Trustee" (such as a bank or private trust company) has the power to make distributions from the trust to the beneficiary. In fact, one benefit of having an Independent Trustee (or Independent Co-Trustee) is that the trust distribution provisions (i.e., the purposes for which distributions can be made) can be much broader when the Independent Trustee makes the distribution decisions.

Although the current estate tax exemption amount is $5,490,000, Congress could reduce that amount in the future. And although the current estate tax rate is 40%, Congress could increase that rate in the future.

The estate tax is much worse than the income tax. The estate tax is a tax on "principal"–i.e., the assets that are being transferred when someone dies. Those assets must be valued at fair market value for federal estate tax purposes. Thus, the estate taxes triggered at death can be very sizeable. If estate taxes are paid on the same assets in each generation as they are transferred to the next generation, that could result in a whole lot of estate taxes being paid over time.

Many people like to transfer wealth to the next generation in a way that provides the various benefits discussed above *and* keeps those trust assets from being subject to estate taxes in each generation.

**To be continued...** In Part Three of this series, we will continue our discussion of trusts and, in particular, the various benefits of irrevocable trusts. We will discuss, in more detail, how irrevocable trusts can avoid estate taxes. We will also discuss the increased income tax options that can be obtained with certain types of irrevocable trusts.

**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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