Estate Planning Insights

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TRUST CONSIDERATIONS

By the time you read this newsletter, the election will have taken place. Rather than try to predict what will happen to the estate and gift tax (and other) laws as a result of the election, we are going to discuss a totally different topic in this newsletter. Of course, once Congress makes any changes to the tax laws, we will send a newsletter discussing those changes. In the meantime, consider the matters discussed in this newsletter: trusts. Trusts are a very important part of estate planning.

What is a Trust? In its simplest form, a trust is a device in which the "ownership" of assets is split into two parts: (i) the legal owner and (ii) the equitable owner. The legal owner of a trust is the Trustee. This means that the Trustee has control over (and title to) the trust assets and is the *manager* of the trust. The equitable owner of the trust is the beneficiary (or beneficiaries–there can be multiple beneficiaries of a single trust). The beneficiary is the person for whose benefit the trust assets are "administered" (managed). The same person can be both the Trustee (or, a Trustee) and the beneficiary (or, a beneficiary) of the trust. When such a person is managing the trust and its assets, the person has her "Trustee hat" on and when the same person receives a distribution from the trust, the person has her "beneficiary hat" on. Thus, a trust is a "pot" of assets that is managed by the Trustee for the benefit of the beneficiaries.

A trust is also a two-part device based on *when* a particular beneficiary has the right to enjoy the trust (i.e., when he can receive distributions from the trust). A trust must have at least one current beneficiary and one future beneficiary, called the "remainder beneficiary," who are different from each other. There can be multiple current beneficiaries and multiple remainder beneficiaries of a single trust. The current beneficiary can receive distributions now, while the remainder beneficiary cannot receive distributions from the trust until the current beneficiary's interest terminates. Most trusts allow distributions to be made either to the beneficiary directly or "for the benefit of" the beneficiary (i.e., the Trustee can pay providers directly for goods and services provided to the beneficiary).

The "parties" to a trust are: (i) the Settlor, also called the Grantor or the Trustor, (ii) the Trustee, and (iii) the beneficiaries. The Settlor is the person who creates the trust. The Settlor can also be the (or a) Trustee or the (or a) beneficiary of the trust. The Trustee must try to follow the Settlor's "intent" when administering the trust.

How is a Trust Created and When is it Effective? A trust can be created while the Settlor is living, to be effective immediately, or a trust can be created so that it only becomes effective upon the death of the Settlor.

If the Settlor wants to create a trust that is effective immediately, he will either use a "Trust Agreement" or a "Trust Declaration." Technically, a Trust *Agreement* would be used when the Settlor and Trustee are not identical. If the Settlor and Trustee are identical (the same person is acting in both capacities) a Trust *Declaration* can be used. In that case, the Settlor and Trustee are not two separate parties who must *agree* to the creation of the trust–the Settlor/Trustee is just *declaring* that a trust is created. The Settlor and Trustee must "execute" the Trust Agreement and the Settlor/Trustee must execute the Trust Declaration. To "execute" a document, the person must sign his name in the presence of a notary public, who must then "notarize" his signature on the document.

If the Settlor wants to create a trust that is not effective immediately, but will only become effective upon his death, there are two ways to do that. One way to do that is to include provisions in the Trust Agreement or Trust Declaration that are applicable only on the Settlor's death. The other way to create a trust that is not effective until the Settlor's death is to establish the trust in the Settlor's Will. In that case, the Settlor of the trust is the Testator (or Testatrix) of the Will. A trust that is created in a Will is called a "Testamentary Trust," which comes from the French word, "Testament," which means the same thing as the English word, "Will." Testamentary trusts have been created in Wills for centuries, although many people today do not know that a trust can be created in a Will, as well as in a Trust Agreement or in a Trust Declaration.

Regardless of which document is used to create the trust (i.e., a Trust Agreement, a Trust Declaration, or a Will), we will hereafter refer to the document creating the trust as the "trust instrument."

The Duties of a Trustee. Serving as the Trustee of a trust is a position of great responsibility. A Trustee is a "fiduciary," which comes from the Latin word, *fidere*, which means "confidence" or "trust." The same Latin root word gave us the English word "fidelity," which means faithful. A Trustee must faithfully observe the terms of the trust and all fiduciary duties under the law.

Trustees (and other fiduciaries, such as executors) are held to the highest standard under the law, referred to as "fiduciary duties." *Some* fiduciary duties include:

1. The duty of loyalty to the trust beneficiaries.
2. The duty to administer the trust in accordance with the terms of the instrument that created the trust.
3. The duty to manage the assets of the trust prudently.
4. The duty to keep the trust beneficiaries informed.
5. The duty to treat multiple trust beneficiaries impartially (unless the trust instrument provides that some beneficiaries have superior rights to other beneficiaries).
6. The duty to avoid conflicts of interest (and self-dealing) with the trust, its assets and its beneficiaries.

The Settlor of a trust can override one or more state law fiduciary duties if he desires, with just a few exceptions. Under Texas law, the trust instrument takes precedence over the provisions of the Texas Trust Code and Texas court cases involving trusts because, as long as what the Settlor provides in the instrument creating the trust is not "illegal" or "against public policy," the Settlor has wide latitude with respect to the terms of the trust that he creates. The Texas Trust Code, and other state law rules, are mostly "default rules" that apply in the case where the trust instrument fails to address a particular matter.

The Trustee of a trust also has duties under the federal income tax laws (and sometimes under state tax laws). We are not going to discuss these income tax matters in this newsletter, but a Trustee definitely needs a good CPA to help him with the trust income tax matters.

The Assets of the Trust. When assets are contributed to a trust by the Settlor, those assets are the "principal" or "corpus" (from the Latin word for "body") of the trust. Of course, the assets of the trust are usually invested in a way that earns income, such as interest, dividends, and rental income. Thus, for state law accounting purposes, the trust has two components: principal and income.

Trusts can own a wide variety of assets, including real estate, stocks, bonds, mutual funds, certificates of deposit (CDs), cash, mineral interests, and interests in private companies, such as Limited Liability Companies (LLCs), Family Limited Partnerships (FLPs), and S Corporations. There is virtually no limit to the *type* of assets a trust can own, although the Settlor may provide limits on the type of investments in the instrument creating the trust.

Trust Investment Considerations. Under the "prudent investor rule" that applies in Texas today, the Trustee has a duty to manage the trust as a prudent investor would, which includes diversifying the trust investments. This duty to diversify the trust assets can be overridden by the Settlor in the trust instrument. For example, a Settlor may contribute the family ranch to a trust and provide that the Trustee *not* sell the ranch even though not selling the family ranch might cause the trust estate to be under-diversified in that case. Further, many Trustees diversify a concentrated trust over time, to spread out the capital gains taxes caused by asset sales over several years.

The trust diversification "rule" comes from the modern portfolio theory of investing. Under the modern portfolio theory, having a variety of assets usually helps the trust estate *maintain its value in the long run* because different assets perform differently under various market conditions. For example, CDs and other cash investments may lose their value when the interest rate is so low that their purchasing power is reduced because of inflation. In these times, having 100% of the trust estate invested in cash is actually "high risk." By the same token, stocks and other publicly traded equity investments fluctuate in value based on interest rates and other economic factors. Even within a single category, such as stocks, there are multiple classes that may perform differently in different market environments. In view of what has happened to the stock market during various "bear" markets and the recent recession, having the trust estate invested 100% in the stock market would be considered "high risk" also. That is why most professional Trustees will diversify the trust estate, even if it takes several years to do so.

The issue of appropriate investments for a trust is also related to the *purposes* of the particular trust. For example, in the case of a "Bypass Trust," the trust estate should be composed of after-tax assets with the greatest potential to grow in value (i.e., appreciate) during the surviving spouse's remaining life because the Bypass Trust assets will pass free of estate taxes to the remainder beneficiaries when the surviving spouse dies, regardless of the value of the assets at that time. In contrast, the trust estate of a Marital Trust should be composed of assets that produce at least a reasonable amount of income for the surviving spouse, but do not grow as rapidly in value as the assets in the Bypass Trust during the surviving spouse's life because the Marital Trust assets *will* be subject to estate tax when the surviving spouse dies. If pre-tax retirement plans are allocated to the Marital Trust (and not the Bypass Trust), this usually produces a better result from an estate tax standpoint.

A Trustee who is not an expert regarding investment matters and modern portfolio theory should always hire a trust investment advisor to help her. Many individuals serving as Trustee make serious investment "mistakes."

Trust Distributions. Some trust instruments restrict distributions that can be made to the beneficiary to the income (only) of the trust. This can be problematic during times when the trust assets do not earn a lot of income. Most trusts allow distributions to be made to the beneficiary of both trust income and trust principal for specified purposes. The *purposes* most often stated for making distributions from a trust are distributions for the beneficiary's health, education, maintenance and support ("HEMS"). The HEMS standard is referred to as the "ascertainable standard" under the federal tax laws. It is frequently used because it prevents various adverse tax consequences for the Trustee, especially if the Trustee is also a beneficiary of the trust. If the Settlor of the trust wants to allow distributions to be made to the trust beneficiaries for purposes beyond HEMS, such as for "happiness" and "welfare," then the trust should have an "Independent Trustee." An Independent Trustee is someone who is not related to or "subordinate to" the Settlor (such as an employee). A bank or private trust company meets the definition of an Independent Trustee and, therefore, is often appointed as Trustee when the Settlor wants to allow broader distributions than permitted by HEMS (as well as for other reasons).

The HEMS standard is not as objective (or limited) as it appears, though. For example, each beneficiary's HEMS needs depends, in part, on that particular beneficiary's "accustomed standard of living." The trust instrument may indicate whether the Trustee should (or need not) consider the beneficiary's own resources and income before making a distribution from the trust.

Types of Trusts Used in Estate Planning. There are many types of trusts used in estate planning. We are only going to mention *some* of them in this newsletter.

Revocable Living Trust: This type of trust is a "Will substitute" used by persons who want to avoid probate or accomplish other objectives not attainable with a Will or with a durable Power of Attorney. While the Settlor is living, the trust is a grantor trust for federal income tax purposes. Also, under state law, the Settlor is still considered to own the assets held in the trust. Upon death, all assets in the Revocable Trust are included in the Settlor's estate for federal estate tax purposes. Thus, a Revocable Living Trust does *not* provide any estate tax, income tax or creditor protection benefits to the Settlor.

Bypass Trust: This type of trust is created on the death of the first spouse, either in a Trust Agreement or in a Will. The primary purpose of a Bypass Trust is to avoid wasting any of the federal estate tax exemption of the first spouse to die. Some of the benefits of a Bypass Trust are (i) future estate tax avoidance, (ii) creditor protection for the trust assets, and (iii) remarriage protection (which some of my clients call "bimbo protection")–i.e., the first spouse's assets held in the trust cannot be given to the new spouse of the surviving spouse. Bypass Trusts can also save income taxes if trust income can be distributed to any of multiple beneficiaries (some in low tax brackets).

Marital Trust: A Marital Trust defers estate taxes until the death of the surviving spouse; however, it does not eliminate estate taxes. It also provides creditor protection and "bimbo" protection. It is commonly used, in addition to a Bypass Trust or other techniques utilizing the first spouse's estate tax exemption amount, in second marriage situations, so that the first spouse to die can take care of the surviving spouse, but have his assets pass to his children, and not to the surviving spouse's children (or new spouse), on the death of the surviving spouse.

Descendant's Trusts: These are "lifetime, protective trusts" that parents and grandparents create for children, grandchildren and other "descendants," to hold each descendant's share of inherited assets or assets received as a gift during the Settlor's life. The primary benefits of using Descendant's Trusts are: (i) the assets held in the trust have divorce protection and general creditor protection, (ii) the Settlor can control where the trust assets go on the descendant's death, and (iii) to the extent that the Settlor's "GST exemption" was allocated to transfers made to the descendant's trust, the assets remaining in the trust on the child's or other descendant's death will escape estate taxes in his or her estate (this avoids a "double death tax" on assets that were already "taxed" in the parent's estate). There can also be increased income tax options, depending on the income distribution terms of the trust. Further, other benefits, such as professional management of the trust assets, protection from too rapid dissipation of the trust assets, making distributions for purposes broader than HEMS, and "keeping the trust assets away from the beneficiary's spouse," can be obtained if a bank or private trust company is appointed as Trustee or Co-Trustee.

"Split Interest" Charitable Trusts: For persons with charitable intent, in addition to making direct gifts to charity during life and upon death, certain "split interest" charitable trusts can be used to provide benefits to both charity and individuals and obtain a charitable deduction for charity's interest. There are two basic types of "split interest" charitable trusts: (i) charitable remainder trusts and (ii) charitable lead trusts. In general, an "annuity" is paid to the Settlor (or Settlor and spouse, or other individuals) from a charitable remainder trust, for life or for a term of years, and when the trust terminates, the remaining trust assets pass to charity. Also, in general, with a charitable lead trust, distributions are made to charity for a term of years, after which the remaining trust assets pass to designated individuals.

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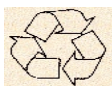

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Irrevocable Life Insurance Trusts ("ILITs"): While the proceeds of life insurance are generally income tax-free, they are not usually estate tax-free. If the insured owns an interest in the policy at death, it is included in his estate for estate tax purposes. To avoid this result, an irrevocable life insurance trust can be created to own the life insurance policy. ILITs are also used to provide liquidity to pay estate taxes, so that other assets in the estate–family business or ranch–don't have to be sold.

Estate Planning Reminder. When a person has created a trust in her Will or Trust Agreement, designed to become effective upon her death, her beneficiary designation forms and account titles should *not* cause assets to pass directly to her beneficiaries instead of into the trusts created for them in her Will or Trust Agreement. Unfortunately, this happens all the time.

Are You Due for a Check Up? We recommend that our estate planning clients come in for a "check up" once every five years. In view of the 2012 elections, clients may want to wait and see what changes Congress makes to the estate and gift tax laws before coming in for their next estate planning check up.

2012 Honors. Karen Gerstner was recognized as a Texas Super Lawyer for 2012 (the 10th year in a row), and also as a "Five Star Wealth Manager" and a Houston Top Lawyer. She is grateful for these awards.

Thank You. At this time of year, we like to say "Thank You" to all of our clients and to all of those who have referred business to the firm. This has been an especially busy year for both estate planning and estate tax work. Working with our clients has been very rewarding and we thank you for the opportunity to serve you. We also thank our referral sources for their continued confidence in us. We wish all of you a Blessed, Peaceful and Joyful Thanksgiving, Christmas and New Year.

Holiday Schedule. Our office will be closed November 21 through November 23 for Thanksgiving, December 24 and 25 for Christmas, and January 1 for New Year's Day. We have been working very hard all year long and are looking forward to a little break, so that we can spend some time with our families and loved ones.

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. You can also reach us by email addressed to:

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