

The Changing Nature of Estate Planning

Part IV -The Use of Trusts

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The use of trusts has exploded over the last several years. According to the IRS in 2002, almost 3.7 million trust and estate income tax returns were filed.¹ By comparison, only 2.1 million C corporation returns were filed in the same period.

Trusts may be the most flexible planning tools available. The creativity is reflected in the various types of trusts which have evolved in the last several years. Total return trusts, dynasty trusts, self-funded spendthrift trusts,² incentive trusts,³ qualified plan beneficiary trusts,⁴ special needs trusts,⁵ and other trust forms have demonstrated the creative flexibility of trusts to solve the

¹ Interestingly, Maryland and the District of Columbia lead the country in trust income tax filings, followed by California, New York, Texas and Illinois. See: www.irs.gov.

² David G. Shaftel, "Alaska's Experience with Self-Settled Discretionary Spendthrift Trusts," Est. Plan. October, 2002; Richard W. Nenno & W. Donald Sparks, Delaware Dynasty Trusts and Asset Protection Trusts, (Wilmington Trust 2000); David G. Shaftel, Newest Developments in Alaska Law Encourages Use of Alaska Trusts, Est. Plan., Feb. 1999.

³ John J. Scroggin, "Family Incentive Trusts," 54 J. Fin. Ser. Prof. 74 (July 2000); Howard M. McCue, III, "Planning and Drafting to Influence Behavior," Miami Est. Plan. Instit. (January 2000); David R. Hodgman and Debra L. Stetter, "Can Incentive Trusts Encourage Children to Behave Responsibly?" Estate Planning, December 2000; Paul A. Meints, "Using Trusts to Provide Incentives, Rewards, Remembrances and Other Benefits to Chosen Beneficiaries: A Checklist," 15 Prac. Tax Law. 25-38 (Winter 2001); Nancy G. Henderson, Managing the Benefits and Burdens of New Wealth with Incentive Trusts (with Sample Provisions), Part 1, 47 Prac. Law. 51 (Sept. 2001); Part 2, 47 Prac. Law. 11-26 (Oct. 2001).

⁴ Virginia F. Coleman, "Preserving the 'Designated Beneficiary' If a Trust is Named as Beneficiary of a Qualified Plan or IRA," ALI-ABA Estate Planning Course Materials Journal, October 2003, at 5; Andrew R. Lee, "Guidelines for Naming a Trust as the Beneficiary of an IRA," Est. Plan., October 2003.

⁵ Kate Dussault & Jeffrey R. Lauterbach, "Special Needs Trusts: Powerful Planning Tools for Disabled Individuals," J. Fin. Plan., January 2002, at 70; Kristen L. Denzinger, "Special Needs Trusts," May/June 2003, at 10; Ira S. Wiesner, "Special Needs Trusts," Trusts and Estates, June 2003, page 24; Keith B. Gallant & Carolyn Reers, "Sometimes It's Better Not to Use a Special Needs Trust," Trusts and Estates, November 2003, at 30. Thomas D. Begley, Jr., "Serving Special Needs," Trusts and Estates, June 2004 at 29.

concerns of clients. A discussion of each type trust is beyond the scope of this article, but it will develop some insights about two approaches: The Dynasty Trust and the Total Return Trust.

Dynasty Trusts

Estate planning process has increasingly focused on the need to preserve family capital across the generations, without losing it to confiscatory transfer taxes and wayward heirs. A Dynasty Trust is a generation skipping trust⁶ designed to exist for the maximum period permitted by applicable state law - the "Rule Against Perpetuities."⁷ Under the English common law, an irrevocable trust could not exist forever, it had to terminate in a "life in being, plus 21 years." However, in the last decade states have begun to broaden the lifetime of trusts or even eliminate the Rule entirely. As a result, there has been an explosion of Dynasty Trusts⁸ in America. Banks are increasingly focusing their attention on Dynasty Trusts as a new product to the consumer market.⁹ Consumer publications are informing their readers of the merits of Dynasty Trusts.¹⁰

⁶ In 2004 the maximum a person can place in such a trust is \$1,500,000. However, the gift tax exemption is limited to \$1,000,000. The amount of the federal GST exemption for both estate and gift tax purposes will match the federal estate tax unified credit exemption amount from 2004 to 2009. See IRC section 2010(c).

⁷ "The Rule Against Perpetuities: An Update," *Tax Management Financial Planning Journal*, December 14, 1999;

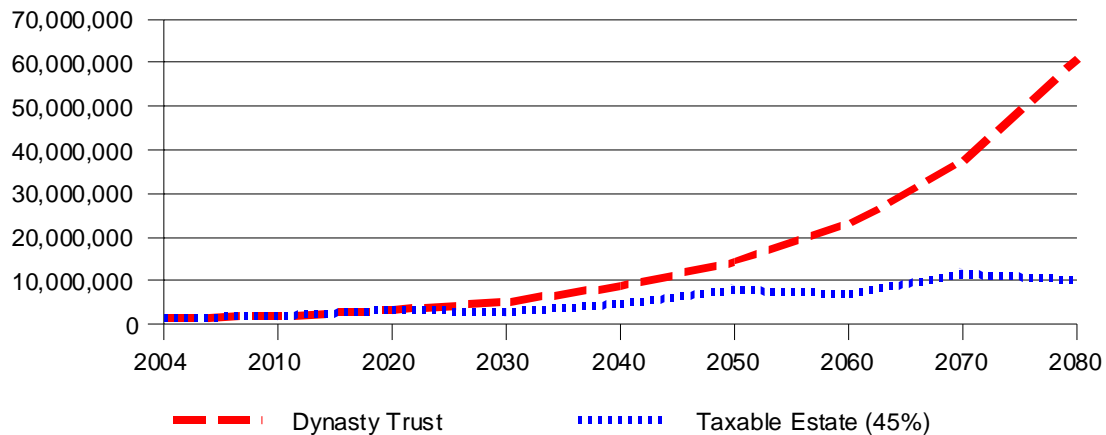
⁸ Martin M. Shenkman, "Dynasty Trusts," *Journal of Retirement Planning*, June 2002; Jerrold I. Horn, "Planning and Drafting for Dynasty Trusts and Perpetuities Issues," ALI-ABA Sophisticated Estate Planning Techniques, September 6, 2001. "The Rule Against Perpetuities: An Update," *Tax Management Financial Planning Journal*, December 14, 1999; "Dynasty Trusts" 1997 Million Dollar Roundtable (Atlanta); "Dynasty Trusts" 1998 ABA Property and Probate Meeting (Dallas); "Dynasty Trusts" AICPA Technical PFS Conference (Las Vegas); "A Generation-Skipping Trust: Unlimited Duration? Why Not?" March 1999, *Trusts and Estates*; "Dynasty Trusts" *The CPA Journal*, September 1996. "Its Your Money," *Chief Executive*, October 1, 1999; "Protect Your Assets - Set Up a Trust," *Medical Economics*, April 26, 1999; "New Dynasty Trust Avoids Estate Tax Forever" *Columbus Dispatch*, April 23, 1999; "Want to Make Like a Rockefeller? Simply Establish a Dynasty Trust," *Salt Lake Tribune*, December 20, 1998; "Wealthy Can Build Dynasties by Investing in Special Trust," *Jacksonville Business Journal*, September 4, 1998; "Dynasty Trusts can be Useful Tax Tools for the Wealthy," *Washington Post*, January 4, 1998. Richard W. Nanno, *Delaware Law Offers Asset Protection and Estate Planning Benefits*, *Est. Plan.*, Jan. 1999.

⁹ For example, at the 2003 and 2004 Miami Institute on Estate Planning virtually every bank and trust company with a booth provided material discussing the Dynasty Trust.

¹⁰ e.g., "Its Your Money," *Chief Executive*, October 1, 1999; "Protect Your Assets - Set

Why does a Dynasty Trust make economic sense? Take a close look at the inter-generational confiscation of wealth as shown in the chart below. Assume a trust starts with \$1,500,000 in 2004 and grows at an annual 5% rate. Every 25 years, a generation dies and 45%¹¹ of the accumulated wealth is confiscated in federal and state estate taxes. The lower line shows the after-tax value if the family retained ownership of the initial \$1.5 million more than 76 years, assuming the family did not spend the funds to support a lifestyle. The upper line shows the value

Dynasty Trust vs Taxable Estates



if the assets were held in a Dynasty Trust.

Instead of losing 45% of the estate to a confiscation tax every 25 years, the Dynasty Trust continues to grow. The compounding of the growth of the funds (which would have been paid in estate taxes) results in significant growth in the value of the trust’s assets. In 76 years, more than \$61 million is held in the Dynasty Trust versus \$10.2 million held by the family. Shown the above calculations, many clients have seen the economic benefit of avoiding the “inter-generational confiscation” of wealth.

If they are properly drafted, Dynasty Trusts can offer a number of planning advantages. Among the benefits:

- X As shown by the above calculations, the growth of assets in the trust far exceeds the growth if the assets remain subject to state and federal death taxes.

Up a Trust,” *Medical Economics*, April 26, 1999; “New Dynasty Trust Avoids Estate Tax Forever” *Columbus Dispatch*, April 23, 1999; “Want to Make Like a Rockefeller? Simply Establish a Dynasty Trust,” *Salt Lake Tribune*, December 20, 1998; “Wealthy Can Build Dynasties by Investing in Special Trust,” *Jacksonville Business Journal*, September 4, 1998; “Dynasty Trusts can be Useful Tax Tools for the Wealthy,” *Washington Post*, January 4, 1998.

¹¹ i.e., in 2007, the federal estate tax will effectively be a flat 45%.

- X Even if estate taxes were eliminated, the Dynasty Trust still offers significant asset protection benefits to heirs. With 49% of U.S. marriages ending in divorce,¹² such a trust can limit the claims of a divorcing spouse and the resulting depletion of assets to non-heirs.
- X Using a special power of appointment,¹³ the trust can provide that each generation has the ability to decide how the next generation will receive benefits from the trust. For example, a son could decide to distribute the trust assets outright to his own children, maintain the trust with modified terms or give trust assets to charity. Thus, although the trust is irrevocable, the trust can be changed as benefits pass from generation to generation. Although the federal tax code does not address the required lifetime of a trust, it does provide that if a trust permits the exercise of a power which would postpone vesting of beneficial interests beyond the lives in being, plus 21 years, or beyond 90 years, the trust will lose its GST exemption.¹⁴ As a result a GST trust should not permit a special power of appointment to extend beyond the rule against perpetuities.
- X The Dynasty Trust can be an excellent tool to hold family business interests. If the Dynasty Trust is created as a “spendthrift trust,” state law may restrict the right of creditors and divorcing spouses of family members to access the funds held in the trust. Moreover, because the assets are held in trust and not by the family members, the management of the trust assets may be retained in the most competent hands (e.g., professional money managers, or family members who run the family business versus family members who may be prone to making bad business or investment decisions).
- X The trust can provide income tax savings by allowing the trustees to “spray” income directly to beneficiaries in lower tax brackets, such as elderly parents or grandchildren who are in college.
- X A number of the states which permit Dynasty Trusts do not impose a state income tax on trust income. Over time the compounding effect of this tax savings could be significant.
- X Some family members will not have children. If assets were transferred directly to childless heirs, a possible benefactor would be the non-blood surviving spouse, who might pass the assets to his or her second spouse or family. To the extent family assets are placed in a Dynasty Trust, this dissipation of assets to strangers to the family is eliminated.
- X Because a trustee stands between the asset and the beneficiary, the trust limits the ability of heirs to spend down the family wealth, assuming of course that the trustee does not

¹² Walter Kirn, “Should You Stay Together for the Kids,” *Time*, September 25, 2000, page 33.

¹³ William S. Forsberg, *Special Powers of Appointment: The Key to Flexibility in Planning*, *Est. Plan.*, Jan. 2000; Alexander A. Bove, Jr., “Powers of Appointment: More (Taxwise) Than Meets the Eye,” *Est. Plan.*, October 2001; Alexander A. Bove, Jr., “Exercising Powers of Attorney - A Simple Task or Tricky Business,” *Est. Plan.*, June 2001.

¹⁴ Treasury Regulation 26.2652-1(a)(4).

mismanage the family wealth.

Given these substantial benefits, most wealthy (and many less wealthy) clients should consider adopting Dynasty Trusts. For example, a plan might provide that four sets of grandparents each draft similar Dynasty Trust provisions and have the separate Dynasty Trusts merge together after the death of their married children. If the children divorced, the trust for each child would remain in place and as each divorced child dies, the Dynasty Trust could continue for the common descendants of both families. However, if additional offspring are born to a new marriage, the merger of grandparents' trusts would generally not make sense.

As the Dynasty Trust continues over time, the beneficiaries of the trust become less and less related to each other. It may make sense to have the trust subdivide so that each family has its own trust share. While this may dilute the trust, it may also reduce the chance for intra-family conflicts among remote heirs. For example, assume a trust is created at the death of two parents and holds \$3.0 million (in 2004). The parents have two children, four grandchildren and eight great-grandchildren. Assume that the trust grows at any annual rate of 5%, each family has two children and a generation dies every 25 years. The table below indicates how much could be in the trust. Although the values are clearly increasing,¹⁵ the impact of the value is diluted as the number of family members increases. The table also demonstrates the need for the trust to be able to subdivide as new family groups are formed. Having a single trust for more than 224 relatives is probably not a good idea.

Generation	Total Family Members	Total Trust Value (rounded)	Value Per Family Member (rounded)
Starting Family Members	14	\$3,000,000	\$214,000
25 Years	28	\$9,675,000	\$346,000
50 Years	56	\$32,764,000	\$585,000
75 Years	112	\$110,951,000	\$991,000
100 Years	224	\$375,718,000	\$1,677,000

All states have not eliminated the restrictions on the Rule Against Perpetuities. For residents of states which have not provided for such elimination, trusts can be created in a state which does allow Dynasty Trusts. It may require the use of an institutional trustee or co-trustee in the state allowing Dynasty trusts. The choice of the appropriate state is dependent upon local fiduciary law, local income tax laws, the type of trust assets and the proximity to the creator of the trust.

¹⁵ However, if an inflation index were applied to the funds in the trust, there might be little to no growth in the benefits which each descendent would receive.

While Dynasty Trusts provide significant benefits, there are other significant issues that have been at least partially ignored in the rush to Dynasty Trusts, including:

- X Is this potential accumulation of wealth well advised for American society? Certainly, Bill Gates' father would argue against it.¹⁶ Others have questioned the long term benefit of the movement to eliminate the Rule Against Perpetuities.¹⁷
- X If these trusts gain wide acceptance and begin to retain significant wealth, will Congress just impose a new tax on the accumulations? Possibly, but the planner should make sure to build enough flexibility into the plan to allow trustees or others to respond to changing laws.
- X As wealth accumulates, conflicts and litigation will follow. Poor drafting, greed, conflicts of interest, mismanagement and similar issues will assure that the probate litigation bar remains busy.¹⁸
- X As wealth accumulates, the potential for and impact of mismanagement will grow. While a son may be able to effectively manage a trust of \$1.0 million, will his granddaughter have the inclination or talents to properly manage a \$60 million trust fund?
- X Effectively, a Dynasty Trust leaves the dead hand of the grantor on the trust assets. Because the trust is irrevocable, the terms dictated by the grantor and his advisors will control in perpetuity. Although flexibility can offset part of this negative, inept drafting can leave the grantor's family suffering adverse consequences over an extended time. Moreover, is it even possible to contemplate and draft for all eventualities over a hundred or more years?

The Dynasty Trust creates an inevitable issue: What will be the impact of accumulated wealth on future generations? Look at the prior chart. Assume a great-grandson has a right to 10% of the Dynasty Trust in 76 years. His 10% interest entitles him to benefits from \$6.1 million of the trust principal. Assuming a 5% return per year, his annual income for the rest of his life is more than \$300,000. When his father tries to convince him to go to college, the son's response may be: *"Dad, I have a \$300,000 a year coming to me - Why do I need to go to college? Why do I need to work?"*

While there are significant economic reasons to create a Dynasty Trust, many clients need

¹⁶ see: William H. Gates, Sr. and Chuck Collins, Wealth and Our Commonwealth, Beacon Press (2003).

¹⁷ See: Verner F. Chaffin, "Georgia's Proposed Dynasty Trust: Giving the Dead Too Much Control," 35 Georgia L.Rev. (Fall 2000) and Ira Bloom, "The Tax Tail is Killing the Rule Against Perpetuities," 87 (no.4) Tax Notes 569 (April 24, 2000).

¹⁸ Wendy Davis, "Time to Specialize in Probate Litigation?" Trusts and Estates, September 2003, at 57. See Part III of this series, "Divorce and Other Conflicts."

to thoroughly address the ultimate impact of such a trust on their families. As a result clients are increasingly adopting structures which limit the benefit family members may receive from the Dynasty Trust. Incentive trusts, safety net trusts, education trusts, and total return trusts can provide a mechanism for limiting the benefits that heirs will receive from the trust. The concept of restrained inheritances was addressed in more detail in part II of this series.

Total Return Trusts

Many trusts provide that trust income is automatically paid to one or more beneficiaries, but the principal can only be encroached upon under certain defined events (e.g., for “emergency purposes”). When income levels were high, such approaches might have made sense, but in the last several years investment returns have been very low and some investment vehicles may not fit the standard income & principal distribution model, creating pressure from income beneficiaries for higher distributions from the trust.¹⁹

As a result, many states²⁰ have adopted or are considering the adoption of approaches which either allow an existing irrevocable trust to be converted to a unitrust (i.e., permit income distributions based upon a stated percentage of the value of the trust), and/or provide trustees broader discretion in allocating funds between income and principal.²¹ Although there is broad movement toward such trusts, the lack of uniformity between states has created a confused mosaic.

There are two basic approaches. The equitable adjustment power (section 104 of the Uniform Principal and Income Act²²) is revised to allow trustees to partially ignore the direct impact of investments on income and remainder beneficiaries and instead invest trust assets based upon obtaining the greatest total return. The trustees have the discretionary right to determine a fair return to income beneficiaries and allocate a portion of principal to income to obtain the desired rate of return.

¹⁹ Richard M. Horwood & Jeffrey A. Zaluda, “A Trustee’s Balancing Act: Income and Remainder Beneficiaries’ Rights,” Estate Planning, January, 2003.

²⁰ At least 40 states have adopted or are considering adopted of total return trust legislation.

²¹ Robert B. Wolf & Stephan R. Leimberg, “Total Return Trusts Approved by New Regs, but State Law is Crucial,” Est. Plan. April 2004; Robert B. Wolf & Stephan R. Leimberg, “Total Return Unitrust: The (TRU) Shape of Things to Come,” 23 RIA Estate Planner’s Alert 6 (Dec. 1998); Alvin J. Golden, “Tru or False: An Analysis of the Total Return Trust,” Presentation to the 30th Annual Midwest Estate, Tax and Business Planning Institute, June 2003, available at www.leimberg.org.

²² A copy of the Uniform Act can be found at www.law.upenn.edu/bll/ulc/ulc.htm

The unitrust approach provides that a trustee (sometimes with beneficiary approval) can convert an existing trust to a unitrust, giving income beneficiaries an assured rate of return. One of the principal difficulties with such a trust is valuing assets which are not readily traded on any market.

The acceleration of states adopting such provisions is at least partially due to an IRS issuance of proposed regulations²³ which provide that such changes may not result in the trust losing the benefit of either the marital deduction or the generation skipping exemption.

However, the state legislation is so new that it should be anticipated that unhappy remainder beneficiaries may argue that the trustee's use or non-use of the new statutes unfairly reduced their potential benefits from the trust. Unless the state statutes provide protection for trustees, this new legislation may open a new litigation door on inheritances.

It should be noted that the above approaches are primarily directed at correcting unexpected consequences in irrevocable documents. As a part of the move to greater flexibility, many trust instruments are adopting similar approaches, without having to comply with the restrictions of a state statute. For example, the unitrust rights in most state statutes runs from 3% to 5%. Assume a client creates a trust for a second wife and wants a higher annual distribution. The client might provide that the annual distribution equals all of the income from the trust, but not less than 7% of the value of the trust assets. Most practitioners and many clients are already familiar with such approaches from dealing with Charitable Remainder Unitrusts.

Clients should also consider using discretionary trusts which rely upon the discretionary authority of an independent trustee to decide the needs of beneficiaries and the amount of income or principal which should be distributed. Obviously, a key element is the selection of a qualified trustee and the possible ability of beneficiaries to remove trustees who do not properly perform their duties.

Effectively Using Trusts

The last several decades have seen huge societal, financial and tax changes. More changes are coming, including probable revisions to the transfer tax modifications adopted in 2001. Clients are demanding both broader discretionary judgment in trustees and more flexibility to deal with future potential and unforeseeable changes. Among the changes resulting from this approach are:

The Trustee's Role. The role of the trustee has largely remained the same for several hundred years. That is, to preserve the assets and income of the trust for the benefit of the life

²³ Proposed Regulation section 1.643(b)(1).

beneficiaries and the remainder beneficiaries by appropriate and prudent investments. Although there have always been discretionary decisions by trustees, the nature of the discretionary decisions is beginning to change.²⁴ While this change is not universal, it is resulting in a substantial reorientation of trustee responsibility.

According to a Boston College study, between \$36 trillion and \$141 trillion will pass by the year 2050 between the baby boomers and their parents.²⁵ According to a study by U.S. Trust, only 10% inherited their wealth and most came out of a middle to lower income class background.²⁶ These millionaires want to provide opportunities for families, without providing them an unearned lifestyle. Because it is impossible to draft for every contingency, these millionaires next door are often relying upon the subjective discretion of a trusted trustee to make the right decisions.

- What is the significance of this change in orientation? Among the implications are:
- X When the first goal of planning is to protect and preserve the family²⁷, it necessitates the choice of a trustee who can make value judgments of what is appropriate in protecting and preserving the family. It is a role that some institutional trustees often dislike. This does not mean institutional trustees should not be used. Instead, it may result in the allocation of trustee responsibilities. For example, having the institutional trustee perform the administrative and investment functions of the trust, while giving the discretionary distribution decisions to one or more individual trustees.
 - X Finding one trustee who has all of the desired characteristics may be impossible. Increasingly multiple trustees are being used to obtain balance and skills that cannot be found in a single trustee.
 - X In many cases, the fees to the individual trustees have been waived, but because of their increasing exposure to fiduciary liability and hands-on responsibility, trustees' fees are increasing. The broad discretionary decisions on how distribution will occur requires greater involvement and responsibility, justifying and often necessitating a higher fee.

²⁴ Glenn Kurlander and Edward J. Orazem, "The Shrinking Trustee," *Trusts and Estates*, June 2004 at 33.

²⁵ See: Schervish and Havens, "Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfer and the Prospects for the Golden Age of Philanthropy," Social Welfare Research Institute, Boston College, Boston, MA, October 1999. See the report at: http://www.bc.edu/bc_org/avp/gsas/swri/

²⁶ A Portrait of the Affluent in America Today, US Trust (March 1998). See also: www.ustrust.com

²⁷ See: John J. Scroggin, "Protecting and Preserving Family - The True Goal of Estate Planning," *ABA Probate & Property* (two parts), Spring and Summer 2002.

Trust Terms. Trusts are perhaps the most flexible devices available to planners to protect and preserve a client's family. One key is drafting for flexibility,²⁸ allowing the trust agreement to meet the challenges which may occur far into the future and which were never anticipated when the documents were drafted. There are a number of trust terms that the client should consider using. These include:

- X Spray Powers. Particularly when parents are being supported or there are minor children facing future college education costs, non-marital trusts can allow the trustee to distribute income to the descendants and/or parents as determined in the trustee's discretion. For example, distributing income to a child in college uses the descendant's lower income bracket to yield greater after-tax income to fund the college education.
- X Trustee Removal. The IRS has acknowledged that both the grantor and beneficiaries can be given the right to remove and substitute trustees without adverse tax consequences. Revenue Ruling 95-58,²⁹ provides that such a power is not considered a power of appointment which would pull the assets into the grantor's or beneficiary's estate.³⁰ The substituted trustee cannot be related or subordinate to the party having such a power.

In many cases it makes sense to permit the grantor or a spouse who is a beneficiary of the trust to remove any trustee (e.g., a child/trustee becomes a problem). Moreover, after the death of the grantor and the grantor's spouse, giving a majority of the adult beneficiaries the ability to remove and substitute a trustee can avoid a legal fight if the trustee does not perform properly. However, to protect against arbitrary action, it may be appropriate to require approval from the remaining trustees, and/or a super-majority (for example, 66-80% percent) of the adult beneficiaries.

If the family does not want to eliminate related or subordinate parties from the list of successor trustees, they may create a provision which allows removal for cause. The IRS ruled in PLRs 9303018 and 9328015 that a related or subordinate party can be appointed in the removal of the prior trustee was for cause. The rulings provide 13 separate causes for removal.

²⁸ Barry A. Nelson & Rosario F. Carr, "Drafting to Achieve Maximum Flexibility in the Estate Plan", Est. Plan., July 1998; Alan S. Acker, "Every Drafter's Dream: The Flexible Irrevocable Trust", BNA Tax Memorandum, 1998, at 295; Neill G Keydel & Frederick R. McBryde, "Building Flexibility in Estate Planning Documents", Tr. & Est., Jan. 1996.

²⁹ 1995-2 CB 91. See also: Robert C. Pomeroy, Trustee Removal and Replacement Powers, ALI-ABA Est. Plan. Course Materials J., April 1999.

³⁰ John J. Scroggin and Robert Petmecky, "Is the Power to Change Trustees a General Power of Appointment," 67 Taxes 520 (August 1989).

- X Successor Trustees. Particularly where the trust is expected to have a long term existence (e.g., a Dynasty Trust), the trust agreement needs to document how successor trustees are chosen. Many potential Co-Trustees will not even be born when the trust is created. A selection process that contains one or more of the following approaches may make sense:
- ! Allowing a surviving spouse to choose the successor trustee.
 - ! Allowing a majority or a super-majority of the adult beneficiaries to appoint a successor trustee.
 - ! Allowing the last named Trustees to choose their successors.
 - ! Allowing the last named Trustees to choose their successors, with the approval of a majority of the beneficiaries.
 - ! Allowing the remaining Co-Trustees to choose the successor.
 - ! Allowing the remaining Co-Trustees to choose the successor, with the approval of a majority of the beneficiaries.
 - ! Giving a third party (e.g., local probate court) the authority to select a successor trustee.
- X Trust Protectors. The concept of special parties having power over trusts is a relatively new concept.³¹ The normal purpose of such powers is to allow a third party to make revisions to the trust's terms to accommodate unforeseen events or to remove a trustee. At least three central questions must be addressed when using trust protectors:
- ! Who should be chosen as a trust protector? Obviously appointing a beneficiary as trust protector may create real or perceived conflicts of interest. To avoid adverse income and transfer tax issues, the trust protector should generally be independent (assuming broad authority is granted).
 - ! How broad should the trust protector's powers be? Many clients are unwilling to grant broad authority to non-family members and many friends and family advisors may not be willing to take on the discretionary power associated with such authority. One solution may be to appoint a trust protector, but require that his or her exercise of power must be approved by a majority of the vested adult beneficiaries who are competent. A simpler approach may be to provide that any proposed actions by the trust protector must be provided in advance with a minimum notice period (e.g., 30 days). A majority or super-majority of the beneficiaries can be given a right at any time to remove the trust protector and name a party who is not related or subordinate as successor.³² The

³¹ Alexander A. Bove, Jr., "The Trust Protector: Trust(y) Watchdog or Expensive Exotic Pet," Est. Plan. August 2003.

³² Pursuant to Revenue Ruling 95-58 (1995-2 CB 91) such a power should not have any adverse tax consequences. Supra note 29.

notice period would give the beneficiaries the ability to remove a trust protector before he or she exercised the proposed actions.

! What happens if the trust protector is disabled or dies? Probably the easiest approach is allowing a trust protector to appoint his or her successor. If such appointment is not made, a majority or super-majority (e.g., 80%) of the vested adult beneficiaries who are competent may appoint an independent successor. In either event the document may require that the successor trust protector be free of any real (e.g., is a beneficiary) or perceived (e.g., not be married to a beneficiary) conflicts of interest.

X Powers of Appointment. Particularly with irrevocable trusts like Dynasty Trusts, granting a person a “Special Power of Appointment” can provide significant flexibility to the planning process. This topic was discussed earlier in this article.³³

X Spendthrift Trusts. A spendthrift trust³⁴ is any trust which provides for two major restrictions. First, it restricts the ability of any beneficiary to assign or otherwise transfer his or her beneficial interest in the trust. Second, a spendthrift trust restricts the right of creditors of a beneficiary to demand payment of income or principal to satisfy the obligations of the beneficiary. In some states, creditors are still free to garnish actual distributions to the beneficiary but are unable to force distributions to the creditor. Such trusts can also restrict the ability of spouses to put pressure on an heir to place assets in a joint name. Virtually every trust should have spendthrift provisions.

But these trusts are not impervious. For example, in Dwight V. Dwight³⁵, a Massachusetts Appeals Court ruled that a trust income from a trust created by a divorced husband’s father could be treated as an increase of the divorced husband’s income, allowing the ex-spouse to claim a portion of it as alimony. A narrow reading of the case would seem to indicate that the decision was predicated upon the trust having an ascertainable standard right, which gave the husband the right to demand support from the trust. Had any distributions been in the absolute and unfettered discretion of the trustee, the ruling might have been different.

X Delegating Responsibility. The trustees may be given the authority to hire a third party or

³³ Supra footnote 13.

³⁴ For more information see: Tax Planning for Family Wealth Transfers, WG&L, section 7.05[1].

³⁵ 756 N.E.2d 17 (Mass.App.Ct.2001).

trust department to handle certain administrative functions.³⁶ For example, an institutional Co-Trustee can provide investment and administrative services if the family trustees do not want to perform these functions. In some cases it may make sense to have an institution perform the functions without being a Co-Trustee, thereby reducing its fees.

- X Domicile. Provisions in the trust instrument can allow the trustees (perhaps with beneficiary approval) to move the state of the domicile of the trust (for example, if local tax laws change) and change the governing state law.³⁷ Other states may offer more attractive tax or trust management opportunities.
- X No-Contest Provisions. The trust may include provisions restricting the ability of beneficiaries to challenge the trust's existence or operation. Although no-contest provisions are outlawed in a few states, they can serve as useful impediment to an heir or creditor who wants to pierce the provisions of a trust.³⁸
- X Limiting the Trustee's Liability. As discussed in the previous article of this series, estate and trust litigation is increasing.³⁹ Because of this increasing threat, trust instruments are increasingly attempting to limit a trustee's liability.⁴⁰ The trust instrument can provide that a trustee is not legally liable to the trust or beneficiaries for actions taken in good faith, unless they constitute gross negligence.⁴¹ The trust instrument might also indemnify a trustee for suits from beneficiaries and third parties, if the trustee's actions were taken in good faith. Finally, the trust instrument might require that any disputes be submitted to

³⁶ Iris J. Goodwin & Pierce McDowell, "Delegating Responsibility: Trustees Explore the Once Taboo," *Tr. & Est.*, March 1999; Roy M. Adams, "Trustees Delegating Investments," *Trusts and Estates*, June 2003, at 80.

³⁷ Philip J. Michaels and Laura M. Twomey, "How, Why and When to Transfer the Situs of a Trust," *Est. Plan.* January 2004.

³⁸ See: Raithel, "Drafting Estate Planning Provisions to Avoid Litigation," *Estate Planning*, February 2000; "No Contest Clauses in California Will and Trusts," 18 *Whittier L. Rev.*, 613-633, 1997.

³⁹ See also: Thomas W. Abendroth, Scott Bieber and David R. Hodgman, "Managing the Risk of Liability in an Estate Planning Practice," *Est. Plan.* August 2003.

⁴⁰ G. Michael Richwine, "How Individual Trustees can Avoid Liability and Breaches of Trust," *Est. Plan.* December 1997.

⁴¹ Richard R. Volkmer, "Exculpatory Clause in Trust Instrument Upheld," *Est. Plan.* July 2003.

binding arbitration.⁴²

- X Modifications. Provisions can be placed in the trust instrument to allow for future non-disposition revisions of the trust instrument. Dispositional changes would fall under the rules governing general and special powers of appointment. Thus, if there are important changes in applicable laws 50 or 100 years from now, the trust may be modified to account for such changes. These modifications should generally be made by the unanimous decision of the trustees and may require approval of adult beneficiaries.
- X Divorce. As discussed in this previous article of this series, any trust instrument should contemplate the impact of divorce or marriage.
- X Supplemental Needs. A non-marital trust instrument may provide that any benefits to beneficiaries supplement any governmental program⁴³ or other sources available to the beneficiaries. The goal is to avoid using trust benefits to the extent governmental or private funds are available to provide needed funds.
- X Consumer Price Index. Because inflation will erode the benefit of any bequest which is expressed in current dollars, bequests set in today's dollars should probably be increased by the Consumer Price Index (CPI).
- X Termination of the Trust. In the future, there may be valid grounds for terminating the trust. In some cases the Trustees by unanimous agreement and possibly with the approval of a majority of the adult beneficiaries could terminate the trust. The critical issue in any termination (by the trustees or by the running of the Rule Against Perpetuities) is how the funds will be distributed at termination. Among the options:
 - ! All funds are distributed to charities designated by the trustees or the grantor;
 - ! All funds are distributed to the oldest generation on a per stirpes basis;
 - ! All funds are distributed equally among all beneficiaries; or
 - ! The trustees select who shall receive the funds.
- X Minutes. To both provide continuity and reduce the chances for litigation, trustees should consider documenting their decisions in writing in a manner similar to how a board of directors documents its corporate decisions. Such historical documentation will be particularly important to manage Dynasty Trusts.

⁴² However, a court might rule that a beneficiary is not bound by the arbitration clause, particularly if all of the beneficiary's claims are not the result of the terms of the trust instrument. See: Merrill Lynch, Inc. v. Nora-Johnson, 797 A2d 226 and Clark v. Clark, 57 P3d 95.

⁴³ Supra Note 5.

Boilerplate trusts are disappearing. Greater wealth is being retained in trusts. The number of trusts being created is increasing rapidly. Trusts are being created with long life expectancies. As a consequence of all these changes, planners are becoming more creative in the flexibility they place in trusts.

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