The Orwellian Look to the Future of Our Practice, or At Least our Estate Planning Practice in 2018

In the year 2525, will we pick out our child from a test tube or a computer screen? Neither; children will be selected from a thought process. We think, therefore you are.

If you created a trust in 1918, one hundred years ago, what would have been factors?

1. The world just finished a war.
2. Automobiles were becoming more plentiful.
3. Food was scary.
4. There were no commercial airplanes.
5. Working conditions were abysmal.
6. Babe Ruth was a pitcher for Boston.
7. Women did not have the right to vote.
8. And on and on.

How many of the factors that we are considering today will be relevant 25 years from now?

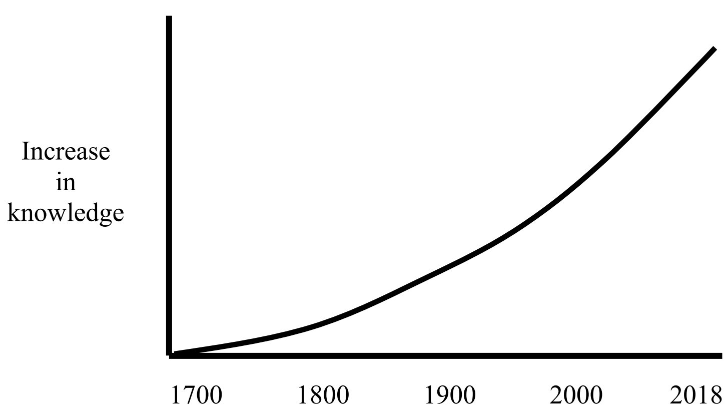
Well, some. Education, medical, and good character.

But how about security?

Domicile?

Security and domicile may be key points to our clients in 25 years, but they are not really part of trust structuring now.

In considering how we approach estate planning for clients, we should be cognizant that the rate of change in our society in terms of knowledge advancement is likely exponential, not linear.



Has the thought process in which we do estate planning changed at this pace too?

No, because we are subject to the behavioral finance status quo bias.

Here then are considerations for our immediate change.

1. SPOUSAL FORMULA IN ESTATE PLANNING DOCUMENTS

The two trusts, the three trusts, the multi trust solution for tax planning in Wills (living trusts) for spouses may be correct, but is no longer the default drafting choice. With the credit bouncing around from $1,000,000 to $11,180,000, indexed, who knows what tomorrow will bring. And states have, or don't have, inheritance taxes.

Recommendation One: Instead of complicated multi trust drafting, as has been done since 1982, the current environment militates in favor of the single-fund QTIP trust. It allows a practitioner to achieve tax planning for their client, as well as the following flexibilities:

1. For the portability decision to be decided at the surviving spouse's passing. Estates may want to include 100 percent of the property in the surviving spouse's estate to achieve a step-up in income tax basis. The goal will be either to make a partial QTIP election to create a credit shelter trust out of the non-elected portion (the $11.180 million estate tax exclusion amount) or a full QTIP election to put all the property in the surviving spouse's estate for basis step-up reasons.

2. For state inheritance tax to be avoidable at the first spouse's passing if that state has a QTIP marital deduction, even if that state has a credit that's decoupled from the federal credit.

3. Ease in drafting.[1]

4. Ease in client understanding.

5. Ease in administration until multiple trusts are created (post-mortem).

2. MARRIED COUPLES

Husband and Wife exist, but so do Spouse and Spouse, Husband and Husband, Wife and Wife, and in year in the future, *Spouse and Spouse and Spouse, or Other and Other, or Who knows what*?

Recommendation Two: Keep an eye on a trend away from husband and wife nomenclature in drafting. Perhaps in the short future drafting will be "Spouse and Spouse." For now, consider using "surviving spouse" versus "my husband" or "my wife." The term "spouse" fits perfectly into documents.

Recommendation Three: Estate planning discussions are easier in the context of "spouses," but limited powers of appointments to "descendants and **spouses** of descendants" can be a bit, as the name implies, limiting. Consider broader limited powers of appointment: "to anyone other than my creditors, my estate, myself, or creditors of my estate."

[1] For those of us who enjoy drafting, we know what the 3 trust plan looks like, with a state exempt, a federal exempt, and a federal QTIP trust all being in place. Throw in there a mismatch of remaining GST exemption from the unified credit, and we have a couple more trusts being called for. The client does not have a chance of recognizing the planning; and the drafter has a strong chance of, ummm, poor drafting if he or she hasn't done a lot of these. All these problems are eliminated with a single fund trust.

3. IRREVOCABLE TRUSTS

We used to be frightened with trust protectors to amend trusts. These powers are essentially providing a broad limited power of appointment to third parties.

Among the problems: Is this a 2036 power? Will this create undue IRS scrutiny? Well, the Times They are a Changin.

Guess what? A third party trust protector power, if properly set up, is not a 2036 power. It may be a power the powerholder does not want to have, but time to consider it in all trusts.

Recommendation Four: Consider protections in irrevocable trusts. Either special limited powers of appointment, broader trust protector provisions, express decanting powers.

a. Briefest approach:

"**Power of Appointment by Special Power Holder.** During my life, the trustee shall distribute the principal to any one or more of my spouse , my descendants, and the spouses of my descendants as the special power holder from time to time appoints during his or her life. I name as the special power holder the first of the following who is from time to time willing and able to act:

(a) my friend and attorney, I. M. Ntrouble

(b) my friend and accountant, Hert M. Eeee."

b. More expansive Trust Protector provision, select provisions:

ARTICLE 1
Trust Protector

1.1 **Designation**. Dean shall be the initial Trust Protector. During my lifetime, [third party] may appoint any one or more qualified corporations, or any one or more individuals other than Disqualified Person as to me, as the initial Trust Protector, Co-Trust Protector, or successor Trust Protector of this trust or any separate trust created hereunder, to act with or to succeed the then acting Trust Protector consecutively or concurrently, in any stated combination, and on any stated contingency; provided that any such designation may be amended or revoked before the designee accepts office. The powers retained in this paragraph may be exercised by a signed instrument filed with the trust records, and any later instrument shall take precedence over an earlier instrument.

1.2 **Powers of Trust Protector**. The Trust Protector may exercise the following powers, at the sole discretion of the Trust Protector:

(a) To appoint successor trustees or co-trustees and remove and replace any trustee of such separate trust, in the manner and under the circumstances described in Article 5 hereinabove.

(b) To make a determination, upon the request of the trustee, of what constitutes reasonable compensation to the trustee.

(c) To change the domicile of the trust.

(d) To resign at any time by signed notice to the trustee.

(e) Subject to any plan created by me pursuant to the paragraph above, to designate any one or more qualified corporations, or any one or more individuals other than Disqualified Persons, as Co-Trust Protector or successor Trust Protector of this trust or any separate trust created hereunder, to act with or to succeed the Trust Protector consecutively or concurrently, in any stated combination, and on any stated contingency; provided that any such designation may be amended or revoked before the designee accepts office. The powers granted in this subparagraph may be exercised by a signed instrument filed with the trust records, and any later instrument shall take precedence over an earlier instrument. If any plan created under this subparagraph shall conflict with any plan created by me pursuant to the paragraph above, my plan shall prevail, whether it was dated earlier or later than the plan under this subparagraph.

(f) To distribute so much of the trust to any one or more of the Beneficiary's descendants, ancestors, siblings, or nephews or nieces in equal or unequal shares, as the Trust Protector shall appoint in writing delivered to the trustee.

1.3 **Release by Trust Protector**. The Trust Protector at any time acting may, by written instrument delivered to the trustee, irrevocably release any of the powers granted to the Trust Protector under this Article. If the Trust Protector irrevocably releases a power, such power shall thereafter no longer be exercisable by the Trust Protector or any successor Trust Protector.

1.4 **Disqualified Person**. The term "Disqualified Person" hereunder shall mean me, any person who has contributed property to such trust, any beneficiary of such trust, the spouse of any beneficiary of such trust, and any individual or entity who would be considered a "related or subordinate party" under Code Section 672(c) as to any of the foregoing such persons, had such person been the grantor of such trust (including without limitation such person's spouse, father, mother, issue, brother, sister, or employee; a corporation in which the stock holdings of such person and the trust are significant from the viewpoint of voting control, and any employee of such corporation; and a subordinate employee of a corporation in which such person is an executive).

c. Decanting Provision:

1.5 **Consolidation and Division of Trusts.** In addition to the decanting powers granted under Florida Statutes Section 736.04117, the trustee shall have the powers set forth in this paragraph. The trustee may at any time consolidate any trust held under this instrument with any other trust if the beneficiaries of the trusts are the same and the terms of the trusts are substantially similar. Further, the trustee, in the trustee's absolute discretion, may divide a trust (the "initial trust") into two or more separate trusts and may segregate an addition to a trust (the "initial trust") as a separate trust.

4. INCOME TAX TOGGLE SWITCHES

To be or not to be a grantor trust.

The most interesting uses of grantor trusts in today's environment continues to be as a positive means of estate tax reduction, or as a means of exchanging assets with a grantor trust without triggering income tax.

In many situations it is advantageous to draft a trust so that the trust has one or more of the characteristics that create a grantor trust. A trust designed in this fashion is often referred to as a "defective grantor trust."

Specifically, the grantor must be okay with the concept that he or she will pay income tax on assets that may or may not be available for use by the grantor. Planners should pay attention to this concern — even if it is flawed on a cash flow basis — because it is perceived as important to most grantors.

For example, a grantor who has a $30 million taxable estate still may not feel that he or she is able to bear the "burden" of income taxes on income not received by the grantor. This conclusion, if not logically grounded on fact, is nevertheless real to the client, and planners need to plan for this reaction. A discussion of cash flow, perhaps accompanied by spreadsheet analysis as to cash flow (to demonstrate the real impact of the burden of paying the income taxes without the accompanying cash flow), may be enough to convince otherwise reluctant clients that the grantor trust is a viable estate tax reduction strategy.

i. <u>Unified credit, applicable credit amount, gifting trust</u>.

In a straight gifting situation in which the grantor gifts property equal to or in excess of the gift tax exemption equivalent ($11,180,000 in 2018), a gift to a grantor trust is preferable to a gift outright. If the gift is of appreciated assets, the donees will realize the capital gain in the future when the assets are sold. However, if the gift is to a grantor trust in which the grantor retains no interest other than that necessary to make it a grantor trust, then future capital gains will be paid by the grantor instead of the trust. In addition, ordinary income and other taxable income incurred annually can be allocable to the grantor of the trust. This has the effect of increasing the estate-tax-free property in the hands of the donees while decreasing the estate-includible property in the hands of the donor.

ii. <u>Grantor retained annuity trusts (GRATs)</u>

GRATs are grantor trusts masquerading as pure transfer tax strategies. Since the GRAT permits payment of both income and trust principal to satisfy the annuity payments the grantor has retained, the GRAT will be treated as a grantor trust for income tax purposes. This means the grantor is taxed on income and realized gains on trust assets even if these amounts may be greater than the trust's annuity payments. This further enhances this tool's effectiveness as a family wealth-shifting and estate-tax-saving device. In essence, the grantor is effectively allowed to make tax-free gifts of the income taxes that are attributable to assets backing the remainder beneficiary's interest in the trust. Consider establishing the distribution to the remainder beneficiaries as a distribution to grantor trusts for their benefit.

iii. <u>Sale to a grantor trust</u>.

The sale is structured by the owner of the asset, which may be a business interest. He or she initially establishes a trust that is effective as a grantor trust for income tax purposes but that is not controlled by the business owner or otherwise subject to an estate tax taint. The heart of the transaction is a sale between the grantor and a third party — *e.g.,* the grantor's family irrevocable trust. This trust will benefit the grantor's beneficiaries. The adult children are often designated as the original trustees of the trust. As a grantor trust for income tax purposes, there will be no recognition of gain on the sale of the asset to the trust. Thus, the difference between the grantor's basis in the asset and the sales price to the trust will not currently be taxed as a capital gain. Further, the grantor will pay income taxes on the income received by the trust because of the assets the trust owns. In this regard, it is as if for income tax purposes the grantor still owns the assets sold to the trust. Importantly, the payment by the grantor of those taxes will not, under current law, constitute a gift to the trust.

Consider then making irrevocable trusts grantor trusts, with the ability to in effect turn off grantor trust status.

Recommendation Five: In grantor trust planning, consider including the power to substitute. The power to substitute assets, a section 675 (4) grantor trust power, becomes especially important as the estate tax exemption increases and income tax planning becomes more relevant for step up in basis purposes. In many settings, a grantor of a grantor trust may want to substitute high basis assets for low basis assets in a grantor trust, and the substitution power is one way this can be achieved (a purchase agreement is another).

Recommendation Six: Another grantor trust power that is currently used by practitioners is the power in the trustee or other party (who is a non-adverse party) to add charitable beneficiaries. Consider the value of having the power to name charitable beneficiaries in grantor irrevocable trusts. Having the power to name charitable beneficiaries allows for (1) shifts in property from private to non private to reduce amounts going to beneficiaries[2] and (2) disincentives to beneficiaries to challenge trustee actions. Under section 674(b)(5), the ability of a non-adverse party to expand the class of beneficiaries is a grantor trust power.

5. CHANGE OF TRUST SITUS TO MORE FAVORABLE JURISDICTIONS FOR STATE INCOME TAX AND CREDITOR PROTECTION PURPOSES.

This seems to be an easy one, but we should emphasize the importance of this to our clients. Two items: we want to be able to change situs to achieve more favorable administration protection under that state's laws.

And we want to be able to change situs and trustees to take income taxation out of one state and put it in another.

For example, if California imposes trust taxation based, *inter alia*, on trustee residency, we would want our California trustee to have the ability to appoint new trustees.

Recommendation Seven: Have both change of situs and trustee designation provisions in the documents, and discuss the BENEFITS to clients, at a follow up estate planning meeting.

1.1 **Controlling Law**. The validity and effect of each trust and the construction of this instrument and of each trust shall be determined in accordance with the laws of Illinois. The original situs and original place of administration of each trust shall also be Illinois, but the situs and place of administration of any trust may be transferred at any time to any place the trustee determines to be for the best interests of the trust.

1.2 **Individual Trustee Succession**. Each acting individual trustee, or the individual trustees acting unanimously if more than one individual trustee is then acting, unless limited in the instrument in which the trustee was designated), may, by signed instrument filed with the trust records, (a) designate one or more individuals or qualified corporations to act with or to succeed the trustee consecutively or concurrently, in any stated combination, and on any stated contingency, and (b) amend or revoke the designation before the designated trustee begins to act. In the event of any conflict or inconsistency between a designation filed pursuant to this paragraph and a designation filed by my spouse pursuant to paragraph 10.4 hereinbelow, the designation filed by my spouse pursuant to paragraph 10.4 hereinbelow

[2] "Gee, my kids really don't need all that money."

shall prevail, and the designation filed pursuant to this paragraph shall lapse to the extent necessary to eliminate the conflict or inconsistency.

5. CREDITOR PROTECTION TRUSTS FOR BENEFICIARIES.

Are lawsuits decreasing or becoming more plentiful, especially plaintiff actions? Although one must be cautious of the representative bias -- seems like there are more lawsuits, but we are only reading about < 1 % of all filed lawsuits, so we really do not know -- but likely there are more lawsuits being filed each year. People are greedy, lawyers are creative, life is more complicated, and people are getting more entitled. All variables to increase the abundance of lawsuits.

If we represent individuals protecting their wealth, they likely want to establish trusts for creditor protection purposes. An interesting development is the distribution of funds to adult, well-to-do children, or, to state it another way, the distribution to adult children who are not spendthrifts. In those instances, there may be no reason to hold funds in trust, at least not for the traditional reason of protecting children against their own self-indulgences. However, creditors, including a child's spouse, lurk in many dark and not so dark corners of the world.

Recommendation Eight: All substantial bequests and gifts should be in a flexible trust format, so that one can argue the creditor protection typically available to third-party created trusts.

Consider discussing with the client the various trustee alternatives to provide a creditor protection shield for funds left in the trust not needed for the child's consumption, as the child determines from time to time. Note the use of the word "shield," versus "insulation." These trusts are intended to balance flexibility for the child in terms of access to the principal, with some protection against creditors, rather than completely insulating.

For planning purposes, assume the client and planner have determined that a flexible creditor protection trust for adult children is desired. Therefore, the question becomes how close to the edge can the trust be pushed. For example, can the child be trustee or a co-trustee? If so, must the standard be a narrow one related to health, support or maintenance? Or should the standard be expanded to "best interests?"[3]

Recommendation Nine: Because powers of withdrawal or general powers of appointment (express) will under case law allow creditors to access that power, eliminate lifetime powers in these trusts for a beneficiary. Instead, make each trust a fully discretionary trust during the life of the beneficiary (child).

The next question is the standard for distribution, as well as the selection of the trustee. The answer is a strange intersection of case law, practitioner bias, and client receptivity.

Ideally, we would like it be someone other than the child, the Generation Two (G2 as has become popular estate planning lexicon. We are a funny group of practitioners).

Most clients want it to be the child.

We know from evolving case law that courts could force a trustee, who is also a beneficiary, to make a discretionary distribution to the beneficiary in order to satisfy a creditor. For example, under the

[3] "Best interests" is a scary standard for trusts controlled by beneficiaries for tax purposes, but perhaps not for creditor protection purposes.

Restatement of Trusts (Third), section 60, paragraph (g), the creditor can reach the "maximum amount the trustee-beneficiary can properly take." In the example under that paragraph, the creditors are able to reach out of the trust, when the beneficiary/debtor is the trustee, "the maximum amount of trust funds that [the debtor] may, without abuse of her discretion, distribute to herself for authorized purposes." The spendthrift provision would not offer a restraint, according to the comment in paragraph (g).

Personally, I like the beneficiary as trustee, with the understanding that the beneficiary could resign as trustee prior to a creditor event occurring, or when the trust is created, the beneficiary (who then has creditor issues or who thinks he or she may) can just decline to act. For those clients with adult G2s, this gives the practitioner the opportunity, if the client consents, to discuss the future planning with those adult children.

But even in this case, a court may look askance at the declination or resignation to act and hold that once that power was available, any actions thereafter taken are ignored. *See, e.g., Bottom, infra* (implying that resigning as trustee would be ignored for purposes of determining the trust's creditor protection).

An alternative would be a co-trustee situation, with the beneficiary having participation rights only as to ascertainable distribution decisions, and the co-trustee having rights as to discretionary distributions for "welfare or best interests." *See, e.g., In re Schwan*, 240 B.R 754 (Minn 1999) (holding trust protected from creditors because of co-trustee and because of fiduciary duties to follow terms of trust and distribution standards). *See also McCauley v. Hersloff*, 147 B.R. 262 (M.D. Fla 1992) (Discretion to make a distribution rested in multiple trustees, of which the beneficiary was only one; therefore, spendthrift protection valid. "Moreover, in exercising that discretion each trustee has a fiduciary obligation to the remaining beneficiaries"); Restatement of Trusts (Third), section 60 (no forcing of distributions if the beneficiary is merely a co-trustee, and the other co-trustee has fiduciary obligations to other beneficiaries, which would almost always be the case).

6. IS GST PLANNING REALLY GOOD PLANNING?

We like to save estate taxes and leave as much money as we can for our clients' beneficiaries. Fun, rational, correct.

But is money to beneficiaries always a good thing? We know "no." Money left to individuals can result in lethargy, bad behaviors, and bad lives.

We can address it by allowing third parties with broad limited powers of appointment to appoint to charities. Second, we really do need to consider the value of "dynastic" trusts. The creator of trusts rarely know their great grandchildren, so why are trusts being set up to leave substantial funds to those distant generations?

<u>Recommendation Ten</u>: Make sure each generation has a testamentary power of appointment, broader than to just descendants. Consider adding trust protectors to allow change in the terms of trusts.

7. "I AM A CHILD, I LAST AWHILE," Neil Young, circa 1968.

The definition of "child" no longer lasts awhile. Genetic manipulation and choice will occur. Birth mothers, perhaps laboratory mothers, may become more prevalent. We will have to tweak what we mean by "child." We may want to expand the definition of "child."

The following provision, regarded as “state of the art” about 10 years ago, is already outdated. Can you spot the anachronisms?[4]

1.1 **Child and Descendant.**

(a) **Child**. A "child" of a person means only: (1) a child born to or conceived by the natural mother of the child during the lawful marriage or civil union of the person to the natural mother, unless paternity is rebutted by clear and convincing evidence; (2) a child born to a gestational surrogate engaged by that person or, if the person is then lawfully married or a party to a civil union, engaged by that person's spouse or partner by civil union; (3) a child lawfully adopted by the person prior to that child’s attaining age 18; and (4) a natural child of the person, if the person's parental rights have not been terminated and either (i) the person is female or (ii) the person is male and the trustee has been provided legally sufficient evidence of the person's paternity or the person has acknowledged paternity in a signed writing.

(b) **Descendant**. A child of a person is a “descendant” of that person and of all ancestors of that person. A person’s descendants include all such descendants whenever born. Except when distribution or allocation is directed to descendants *per stirpes*, the word “descendants” includes descendants of every degree whether or not a parent or more remote ancestor of a descendant is also living.

(c) **Child in Gestation**. A child in gestation on the date any allocation or distribution is to be made shall be deemed to be living on that date if the child is subsequently born alive and lives for at least 90 days.

8. STABILITY

The world is becoming a much smaller place. Will our clients’ descendants continue to be US Citizens? Is their security in place? What kind of food considerations will be more relevant in the future. All things considered, we in the United States are doing quite well, but what will it be in fifty years?

<u>Recommendation Eleven:</u> Trustee guidance could consider distribution of funds to allow beneficiaries to move to jurisdictions outside of the United States, to allow distributions for security measures for beneficiaries, and also to consider distributions needed to modify food/food production. Can we think of any other? I suspect yes.

Conclusion: The world is not static, and our estate planning practice should not be either. As we continue to hone our techniques, attorneys should continue to expand on flexibility and creativity in our planning.

[4] E.g., “maternal”, “paternal”, “natural child”, “females”, and so on. Are these terms clear enough anymore?