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INTEGRATED PLANNING

WHY ALL TRUST ARE NOT CREATED EQUAL

And What to Look For So You Can Tell the Difference and Protect yourself

By

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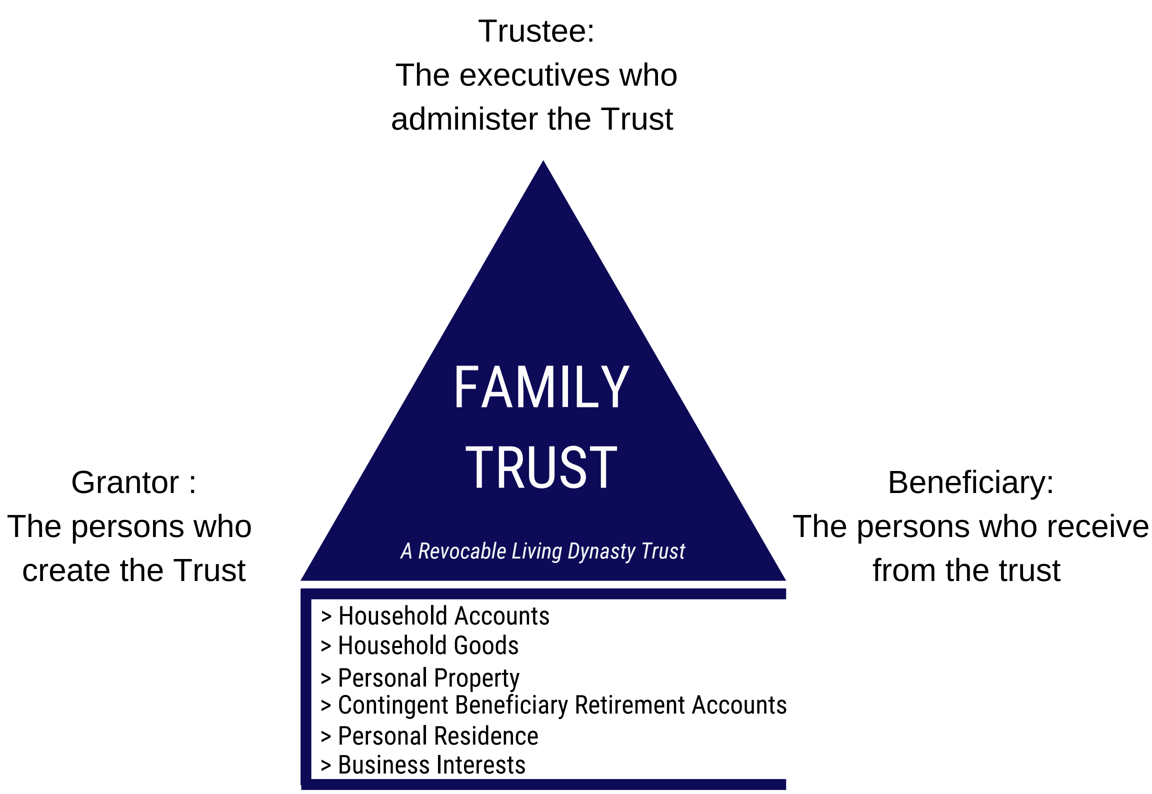

Should I Trust My Trust?

In today's day and age, when all legal documents are prepared on a computer, it seems reasonable to assume that all trusts will be more or less the same. After all, attorneys are notorious plagiarists and routinely copy documents from one another. Isn't one living trust, for example, pretty much the same as another?
Absolutely not! In fact, there are major differences in trusts, and what you don't know about the differences can cost you a great deal of money and aggravation. (This is true both for end users and for the attorneys who prepare trust documents.)

The purpose of this book is to share some of the insights I have gained through reviewing and drafting thousands of trusts from all over the U.S. and many off-shore jurisdictions.

1. Danger Signs. Although having an attorney periodically review your trust is always advisable, you can and should review and evaluate your own trust from time to time. Aside from obvious update or intent issues that you may find, there are also substantive provisions that you can check. Although not exhaustive or conclusive, the following checklist provides some of the major danger signs that a trust may not be adequate or appropriate:

- ❑ Too old - the Trust has not been updated in the last ten years. Even the best of trusts become obsolete over time as the law and circumstances change.
- ❑ Too short (16 pages are simply not enough to include everything that ought to be in most trusts).
- ❑ No A-B-Q-D provisions for revocable trusts (Survivor's, Credit Shelter, Q-TIP and/or Disclaimer). Some simpler or smaller estates may not need all of these provisions if probate avoidance is the only purpose of the Trust. However, even with smaller estate, and notwithstanding high or rising estate tax exclusions, there are many non-tax reasons for such provisions in a Trust.
- ❑ Long, awkward or inappropriate name (If your trust name has more than three or four words, there is probably trouble). Long names, in addition to being inconvenient, show a lack of attention to detail for how the Trust is going to be implemented over time.
- ❑ Uses the word "revocable" in the trust name. Most "revocable" trusts become irrevocable over time, which makes it awkward if the name of an irrevocable trust has the word revocable in it.

❑ No deeds, assignments, or other transfers to the Trust. Without funding, a Trust technically does not exist.
❑ No Schedule of Assets transferred to the trust. Some assets are not transferred to the trust by deed or assignment but by contract (such as the paperwork with the bank for bank accounts). Such assets should be listed on a schedule.
❑ Recommendation by trust preparer to leave assets out of the trust. I have encountered advisors recommending that the Trust be funded at death through a pour over will. This makes probate necessary and thereby enables the advisor to "double dip" and get paid twice for the estate.
❑ Names and other critical information buried in the text rather than set out at the beginning or the end.
❑ Trust not prepared or reviewed by an attorney.
❑ Unnumbered and/or unlabeled paragraphs.
❑ No named Successor Trustees (or less than three).
❑ No provisions handling "community" or "joint" property.
❑ No provisions for dealing with changes in the Rule Against Perpetuities.
❑ No Generation-Skipping Transfer Tax planning provisions.
❑ No Protector (important for all trusts, but especially for irrevocable trusts).
❑ No system for handling disputes and avoiding law suits.
❑ The Trust is dependent upon or tied to just one state or jurisdiction.
❑ THE TRUST IS MISSING ONE OR MORE OF THE PROVISIONS DISCUSSED BELOW:

2. The Spendthrift Shield to Creditor's Claims. To be complete, virtually every trust should include a "Spendthrift" provision. Spendthrift provisions protect the trust assets from being involuntarily seized to satisfy creditors' claims against a beneficiary. In effect, a Spendthrift provision prevents the Trustee from making distributions that would be taken away from the beneficiary. For revocable living trusts, the spendthrift provision comes into effect only after at least one of the grantors is deceased. Also, even if a trust has spendthrift provisions, the spendthrift clause can be frustrated by inappropriate mandatory distribution formulas. To preserve the protection that the spendthrift clause provides, it is vital that the distribution provisions be discretionary. Astonishingly, too many trusts either have no spendthrift provisions, or render them useless with ineffective distribution provisions.

3. The Defense of Discretionary Distributions. Many poorly drafted trusts provide for mandatory distribution at a certain age, or upon certain conditions such as death of the Grantor. Although this arrangement is simple, and common, it is dangerous. When assets arbitrarily distribute from a trust based on the beneficiary's birthday, all the other benefits of having a trust are immediately lost. With mandatory age-based distributions there is no way to avoid a harmful distribution. For example, without discretion to avoid a distribution, money will come out of the trust even if it will be lost because a beneficiary is in the middle of a bankruptcy, divorce, lawsuit, business failure, drug or gambling addiction, or one of life’s other little disasters. When the trustees have no discretion to avoid distributions, the trust may end up hemorrhaging money at the worst of all possible times.

4. No Cap on Discretion. The level of discretion can be established when the trust is created. It can be very broad, and permit discretion to distribute both principal and income, or it can be narrow and restrict distributions to income only or to a specific percentage or dollar amount. For smaller estates, it may not be cost effective to keep the Trust going for a long period of time. It may be prudent to delay distributions to avoid spend thrift issues, but then it may be in everyone's best interests for the trust to distribute everything and shut down. For larger estates, however, putting a cap on distributions is a vital tool to protect the corpus over time. The cap can be a dollar amount adjusted for inflation, a percentage of net assets, annual income, or a combination of these approaches. For true "dynasty" planning, protecting the corpus of the Trust so that it will last over multiple generations is critical.

5. Avoid the Tyranny of an Inappropriate Trustee. Naming the wrong trustee can do just as much if not more damage than having a poorly drafted trust. Without the right trustee, the purpose of a trust can be frustrated or destroyed. There are many situations where it is far better to have family members serve as trustee. There are other situations, however, where a bank or corporate trustee is absolutely the best alternative. It is important to know which is right for your particular family. Also, certain transactions involving an irrevocable trust require a “non-subordinate trustee” — one who is not a spouse, sibling, or child. Often, people are simply directed to one kind of trustee or another without seriously evaluating what is best for their unique situation. For the most part, family member trustees are easier to work with, cost less, and allow greater flexibility.

Nevertheless, it is often better to have a bank trustee where there is a high risk of a family fight, a lack of financial sophistication among family members, a risk of trust assets being depleted through abuse or neglect, no adults (only minor children) in the family, a disinheritance or unequal distribution, or no living descendants. There are also a number of combination arrangements that can be made — for example, having a family trustee that must take the investment advice of a corporate fiduciary or investment advisor. Many of the expenses and problems that arise in running a trust can be avoided by carefully selecting the appropriate trustee.

6. Maximizing the Trust Benefits with Dynasty Provisions. Not having Dynasty Provisions is like having no trust at all for the children and grandchildren. Dynasty Provisions enable the trust to continue in existence for the maximum amount of time permitted by law. The inclusion of Dynasty Provisions means that the benefits of having a trust will continue as long as possible. Generally speaking, a trust may continue in effect for the lifetimes of the children and grandchildren of the grantors (which means there must be sub-trusts for both). In some places, trusts are prevented from existing forever by an archaic and confusing rule of law called "the Rule Against Perpetuities." A number of states (and foreign jurisdictions) have abolished the Rule Against Perpetuities. A well-drafted trust will permit the situs of the trust to move to a jurisdiction that has thrown out the Rule Against Perpetuities — so that the trust is not compelled to arbitrarily terminate. If a trust is worth setting up in the first place, it is worth including Dynasty Provisions so that it can last for as long as it will benefit the family.

7. Beneficial Enjoyment of Property. A well crafted Trust will give the Trustee discretion to permit beneficiaries to enjoy assets held by the Trust without distributing the assets. This enables the beneficiary to have the use of an asset, such as living in a home owned by the trust, while retaining all the tax and asset protection benefits of the Trust. An indicator of a poorly or inadequately drafted trust is one that simply distributes the assets without permitted enjoyment and use without distribution.

8. Protection Against Abuse & Dissipation. A trust should be structured so that it will truly benefit, rather than harm, the beneficiary. One of the most tragic challenges in administering a trust is to have a beneficiary that uses trust proceeds to finance a self-destructive lifestyle of drugs, gambling or alcohol abuse.

To prevent such misuse, a well-drafted trust will permit the trustee to withhold trust funds if a beneficiary has an addiction to such harmful substances. The trustee should be empowered to use the trust assets where appropriate for the beneficiary's health care, rehabilitation, and other needs, and at the same time have the power to stop providing trust assets to feed a beneficiary's self-destructive habits. Sadly, failing to include such protection in a trust is a very common error, and we have seen horrible consequences for the family and the estate as a result.

9. The Protector and Risk Minimization. A trust without a Protector, is a trust at risk. The Trust Protector is a neutral third-party with no beneficial interest in the estate, who has certain specific powers with respect to the trust. Generally, with certain exceptions, the Protector's powers cannot be unilaterally exercised, but must be invoked by the grantor or a majority of the adult income beneficiaries. Typically, the Protector will have the power to do at least two things: ① remove a trustee that is not cooperating or harmful to the trust, and ② fine-tune the provisions of the trust to recover from a "tax ambush" — which is what happens when Congress changes the tax rules on a trust after it has become irrevocable. Protector provisions are particularly important for irrevocable trusts — which even so-called revocable trusts will eventually become. Although some jurisdictions now recognize protector provisions by statute, too many trusts are put at risk because, without a Protector, they have no means of making course corrections once the trust is irrevocable.

10. Customizing the Trust with Statements of Wishes Creating Incentives. A well-drafted trust will not merely give a beneficiary "something for nothing," but will incorporate the grantors values and perhaps create incentives for the beneficiary to do what is right. The best vehicle for accomplishing this is for the trust to recognize and permit the grantor to make Statements of Wishes. Statements of Wishes are technically "non-binding precatory instructions" to the trustee. They permit the grantor to make value statements and give the trustee instructions on when, where and how the trust is administered. When a trust recognizes the grantor's Statements of Wishes, it enables the grantor to customize the trust to fit the unique family needs without incurring substantial attorneys' fees, and without "hardwiring" in provisions that must be removed by amendment when circumstances change. Recognized Statements of Wishes make family values, and the grantor's wishes, part of the legacy in a trust.

11. Avoid the "Spoiled Rich Kid" or "Trust Baby" Syndrome. The last thing most people want is for their wealth to ruin the up-and-coming generations. This is especially true of those who have a strong work ethic, and believe that all of us should be productive members of society. Statements of Wishes creating incentives, in combination with discretionary distribution provisions and protection against abuse are powerful tools to help prevent a trust from spoiling the beneficiaries. There is simply no way to predict in advance when a particular child or grandchild is going to be ready to handle the money that comes out of a trust. One might be ready at age 18, while another might not be ready at age 40. The same beneficiary may be ready at one age, and not ready at another age. Experience has taught that rather than making mandatory incremental distributions based on age or particular events, it is better to give the trustee the discretion to either make or not make a distribution based on need and ability, and based upon satisfying the conditions set by the Statements of Wishes. When all the pieces to a trust fit together properly, it will encourage and reward the children and grandchildren for living useful and productive lives, and minimize the risk of spoiling posterity.

12. Flexibility and Planning for Tax Minimization. There are many highly technical aspects of planning a trust that go beyond the scope of this article, but which will make a major difference in how the trust is administered, taxed, and distributed. An inappropriate provision can be both costly and aggravating. Some issues to consider include the following:

- ❑ Is there equalization between branches of the family notwithstanding unequal gifts?
- ❑ Are there provisions to make up for special expenses such as weddings or schooling expenses that older children may have had but younger children not received yet?
- ❑ Does the trust include A/B provisions or disclaimer provisions to protect the unified credit of the first spouse to die?
- ❑ Does the funding formula for trust B permit some flexibility in selecting assets, or does it lock the surviving spouse into an inflexible and arbitrary allocation?
- ❑ Does the trust have a "safety valve" to prevent income from trust B increasing the size of trusts A and Q when they already exceed the lifetime exemption of the surviving spouse?
- ❑ Is there a requirement to exhaust trust A before trusts Q and B in order to minimize estate taxes on the second death?

- Does the trust permit income to “spray” to the grandchildren from trust B to provide for present needs?
- Does the trust utilize the maximum Generation Skip tax exemption?
- Does your trust accommodate "portability" of the lifetime exclusion?

These are just a few examples of highly technical concerns. Most deficiencies in these areas are found in trusts that are simply too short to deal with the technical issues.

13. Avoid Penalties of Poor Marital Tax Planning. Too often, trusts fail to take advantage of the benefits that the law provides married couples, and may unnecessarily expose the trust assets to avoidable risks and taxes. A simple “I Love You Trust” where husband and wife leave everything to each other, for example, can cost hundreds of thousands of dollars in avoidable estate taxes. As another example, does the trust maximize the use of community property where permitted? Also, the inclusion and funding formula for a Q-TIP (Qualified Terminal Interest Property Trust) should be based upon such factors as disproportionate age between husband and wife, disproportionate assets (significant separate property) between husband and wife, blended families (children from prior marriages), financially unsophisticated or vulnerable spouse, marital disharmony, one spouse with a high risk profession or business, and high risk of health care costs for the surviving spouse. Are there provisions to allow the surviving spouse to disclaim assets (and get future appreciation out of the survivors taxable estate)? Marital tax planning is a virtual field loaded with land mines for the unwary to step on.

14. Know Asset Protection or No Asset Protection. When a trust ignores asset protection issues, it is like leaving your own money on the table for someone else to pick up. All trusts cannot protect all assets at all times. All trusts can, however, protect some assets at some times, and a well-drafted trust will include provisions that maximize the asset protection available under the law. Frequently overlooked features that give some asset protection in the children and grandchildren’s generations are the Spendthrift, Discretionary, and Dynasty provisions discussed above. None of us would deliberately put our money (or our children’s money) in a bank if we knew it could be seized by the creditors of other depositors. Why should we do essentially the same with a trust?

15. Follies of the Failure to Fund. One of the most common mistakes made with a revocable living trust is to leave assets out. This is generally the result of either a lack of understanding of how a trust works, or bad advice from the trust preparer. A common misconception is that if there is a Pour Over Will no funding is necessary. (This results in a probate and effectively converts the living trust into a testamentary trust.) In some cases we have seen a trust preparer erroneously recommend leaving assets out of a trust — this is almost always a mistake (unless the assets are so small and inconsequential that there will be no probate). Leaving significant assets out of the trust means that there will be a probate. In some rare cases we have seen attorneys give that advice in order to "double dip" — to get paid for putting the trust together and to get paid again to do the probate because the trust is not funded. Stay away from any advisor who makes such a recommendation. A trust without assets is no trust at all. The bottom line is, if you are going to spend the time and money it takes to set up a trust, you might as well get all the benefits it will provide by putting your assets into the trust.

16. Mechanism for Avoiding Estate Devouring Lawsuits. One of the most destructive events that can happen with a trust is for the various parties to sue each other. Obviously, problems occasionally arise which must be resolved, and which may require the intervention of the courts. At the same time, it has been said that law suits are a mechanism for disinheriting the family and leaving everything in an estate to the lawyers. A well-drafted trust will strike a balance by providing for dispute resolution in a cost-effective manner, while at the same time eliminating the filing of law suits as an automatic response to every difficulty that may arise. We have found that the most comprehensive and effective procedure for accomplishing this balance is the alternative dispute mechanism of communication, negotiation, mediation, and arbitration found in the Integrity Agreement. Generally, healthy and functional family members will seek to avoid litigation in any event. When there is no established procedure for solving problems as they arise, other family members can be held hostage by those who see litigation as an effective way to get their own way or to obtain a bigger "piece of the pie." Harmful inter-family litigation can be avoided by including appropriate safeguards in the trust.

17. Jurisdiction Dependency. Most people move at some time during their life. Most people's children do not live in the same place they live. This has consequences for trust planning. When a trust is tied to or dependent upon one particular jurisdiction, it becomes immediately obsolete or awkward to administer when a family member is no longer living in that particular jurisdiction. This is an example of "key hole" legal planning, where the estate plan is viewed through the key hole of the one state in which the Grantor or the Grantor's attorney happens to live, without seeing the big picture of what is going to happen over time and across jurisdictions. The best trusts are crafted in a way that makes them portable and jurisdiction independent. This means they can function in any location, and can move to a location that best suits the needs and concerns of the parties and the properties over time and across geography.

18. Business Entity Bypass. It is quit common for the attorney who sets up the trust and the attorney who forms business entities to not be the same attorney. There is nothing wrong with this per se. The trouble comes when each ignores the other. Business entities, like all other assets, should be owned by the trust. When they are not, they are subject to probate. The trust can, in fact, function as a powerful succession tool for business entities. Leaving the LLC or the Corporation or the Limited Partnership out of the trust is a grave oversight with serious consequences. An estate plan and business plan are "integrated" only when the pieces are connected and fit together. Make sure your trust owns your company.

19. Enough is Enough. So often when people have a trust they believe that they are done with their estate planning. While a trust is a vital part of an estate plan, and a good step in the right direction, it is not the entire plan. In addition to the potential omissions and poor planning discussed above, not having the ancillary planning is a critical error. This can be as simple as omitting basic documents such as powers of attorney, living wills, medical directives, and a pour over will. It can also be as serious as failing to integrate business entities, family members and the advisory team. This is the kind of trouble that will be identified and dealt with effectively as part of a second look conference with an independent advisor if you already have a trust. A trust, no matter how good and effective, is the beginning of estate planning, not the end.

20. What to Do About It? If any of these matters are a concern to you, here are some practical steps you can take:

- ❑ If you have a trust already, read it yourself and/or have it reviewed by a qualified attorney or estate planner.
- ❑ Check your own trust against the concerns listed in this article.
- ❑ Review the letters of instruction that you received with your trust and make sure you have completed all action items.
- ❑ Make sure all your assets are transferred to your trust.
- ❑ Schedule a review conference with the attorney or planner who prepared your trust.
- ❑ If you have a trust that was prepared by a non-attorney, with very rare exceptions, we strongly recommend you have it reviewed by an attorney.
- ❑ If you do not have a trust, explore whether one is appropriate for you.
- ❑ Select a qualified attorney or estate planner who is familiar with the kind of planning issues raised in this article — there are many highly qualified attorneys who practice in this area — check them out carefully.

21. Sample Questions to Ask a Prospective Attorney: You want to be totally comfortable with any attorney or estate planner you choose to work with. In addition to being technically qualified, it is important that the attorney be able to communicate with you in a way that you can understand. The following sample questions may help you learn more about whether an attorney is the right one for you:

- ❑ How much of your practice is involved in estate planning? (Unless your estate is very small, avoid the “dabbler” who does it only once in a while)
- ❑ How long have you been practicing in the estate planning area?
- ❑ What is the typical size of the estates you plan?
- ❑ Do you handle both pre-death planning and post-death trust administration?
- ❑ Have your trusts been audited or reviewed by the IRS?
- ❑ Have your trusts been litigated, and if so, with what result?
- ❑ What ongoing services and costs are involved in setting up a trust?
- ❑ How are you rated by your professional peers (Martindale-Hubbell)?
- ❑ What distinguishes you from others who practice in this area?
- ❑ How often do you review trusts prepared by other attorneys?
- ❑ How often and on what conditions do you recommend that people keep their trusts prepared by other attorneys?
- ❑ Do you offer a complimentary initial consultation?

22. Conclusion: What you don't know about your trust can hurt you (or at least cost you and/or your estate money). Because a trust is going to affect the lives and well being of many generations, it is worth doing it right. The final questions are: if you died today, are you certain your present trust will accomplish what you want? If not, what are you doing about it?

In fairness, in reviewing hundreds and perhaps thousands of trusts, many of them are very good, well structured, and highly effective. One of the benefits of reviewing other high quality trusts is the ability to capture good ideas and incorporate them into the documents we use. Not every trust needs to be replaced. When we find a good trust that is adequate to the client's purposes, we prefer to leave it in place. Often, the client just needs help putting to good use what they already have in place.

Now What? Do you understand your trust? Do you remember why you put it together? Is your Trust everything you want it to be? Would you like a second opinion? ***Do something about it. Take action.***

Now What?

To schedule your free Trust Review and consultation
Call 480.324.8000 or email info@DurfeeLawGroup.com

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