Session 2: Estate and Tax Planning with Trusts

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I. Overview

a. What is a Trust?

i. A trust is a fiduciary arrangement that is governed by an agreement (i.e. a trust agreement) between a grantor[1] and a trustee.

ii. The grantor transfers assets to the trust, which pursuant to the trust agreement is a newly created legal entity.

iii. The trustee manages the assets for the beneficiaries in accordance with the terms of the trust agreement.

b. Governing Law

i. The Arkansas Trust Code[2] consists of default rules that apply only if the terms of a trust do not cover a particular issue; provided, however, that in some instances provisions of the Arkansas Trust Code may not be overridden.[3]

ii. Except as specifically provided therein, the Arkansas Trust Code is applicable to trusts "created on, before or after September 1, 2005."[4]

c. Types of Trusts

i. Revocable vs. Irrevocable Trusts

[1] Also sometimes referred to as the "settlor" or "trustor".
[2] ARK. CODE ANN. § 28-73-101 *et seq*.
except as specifically provided in the Arkansas Trust Code, applicable to trusts "created on, before or after September 1, 2005").
[3] *See* ARK. CODE ANN. § 28-73-105.
[4] ARK. CODE ANN. § 28-73-1105(a)(1).

1. A trust is "revocable" if its terms allow it to be amended or revoked at any time by the grantor of the trust.

2. A trust is "irrevocable" if its terms do not allow the grantor to amend or revoke the trust.

3. What if the terms of a trust do not state whether the trust is revocable or irrevocable?

   a. "Unless the terms of a trust expressly provide that the trust is irrevocable, the settlor may revoke or amend the trust. This subsection does not apply to a trust created under an instrument executed before September 1, 2005."[5]

   b. The Arkansas Trust Code reversed the common law presumption in Arkansas that a trust instrument which is silent will be presumed to be irrevocable, however, the common law presumption of irrevocability remains in effect for all instruments executed before September 1, 2005.[6]

ii. Inter Vivos vs. Testamentary Trusts

1. An "inter vivos" trust is a trust created by the grantor during the grantor's lifetime, and can be either a revocable trust or an irrevocable trust.

2. A "testamentary" trust is created upon the probate of a decedent's last will and testament. Testamentary trusts are, in most cases, irrevocable.

[5] ARK. CODE ANN. § 28-73-602(a).
[6] *See* Lyn Foster, *The Arkansas Trust Code: Good Law for Arkansas*, 27 U. ARK. LITTLE ROCK L. REV. 191, 238 (citing *Rogoski v. McLaughlin*, 228 Ark. 1157, 312 S.W.2d 912 (1958) for this proposition).

d. Initial Considerations in Trust Planning and Choice of Trust Type(s)

i. Client's Objectives. Planning with trusts will be different with each client as each plan should be crafted to best meet the objectives of the particular client. Objectives may include the following:

1. Efficient and effective transfer of assets to the next generation.

2. Providing financial security for a surviving spouse.

3. Providing financial security for descendants.

4. Providing support for educational expenses to children and/or grandchildren.

5. Providing for a special needs beneficiary.

6. Avoiding probate and associated expenses.

7. Estate and generation skipping transfer tax planning.

8. Asset protection planning.

ii. Family Dynamics. Relationships between family members should always be discussed, as these relationships should be reflected in the terms of the trust, such as with trustee designations and the disposition of specific assets.

iii. Detailed Asset List. Before a determination of what type of trust(s) will be best to achieve a client's objectives, taking into account family dynamics, the client needs to provide a detailed asset list, with such list to include how such assets are titled and in regard to non-probate assets how beneficiary designations are currently stated.

iv. Funding the Trust. After the type of trust is chosen and the trust agreement is drafted and executed, the grantor must properly fund the trust. This consists of transferring assets to the trust during the lifetime of the grantor and/or making assets payable to the trust upon the death of the grantor. This process should be discussed in connection with the review of the detailed asset list, and then implemented in connection with the execution of the trust.

II. Revocable Trusts

a. General

i. A revocable trust is created during the lifetime of the grantor. This is why a revocable trust is commonly referred to as a revocable <u>living</u> trust.

ii. A revocable trust may be created by one grantor or multiple grantors.

iii. A revocable trust becomes irrevocable upon the incapacity or death of the grantor.

iv. If there are multiple grantors, a revocable trust generally becomes irrevocable upon the incapacity or death of one of the grantors.

b. Benefits of a Revocable Trust

i. Probate Avoidance

1. Disposition of assets pursuant to the terms of a revocable trust is not subject to the probate process.

2. Ancillary probate can be avoided if the trust is funded with assets located in states other than the state of the decedent's domicile.

ii. Privacy. The provisions of a revocable trust and the disposition of assets pursuant to the terms of the trust is private, unlike the provisions of a last will and testament that is probated and on file with the court. However, if the revocable trust is not fully funded and the last will and testament must be probated to transfer assets to the revocable trust, the identity of those probate assets may not be private, even though the disposition of those assets will be since such disposition would still be accomplished under the terms of the revocable trust.

iii. Management Upon Incapacity. A revocable trust ensures that if the grantor becomes incapacitated, a successor trustee will serve to ensure the trust assets will be managed and used for the grantor's benefit during such period of incapacity.

iv. Tax Planning. Revocable trusts are good mechanisms to implement estate tax and generation skipping transfer tax planning, as well as asset protection planning for the next generation(s).

c. Tax Planning

i. Marital Deduction/Bypass Trusts (AB Trust)

1. Upon the death of the first spouse, the typical AB Trust plan has provided for:

a. Allocation of an amount equal to the decedent's applicable exclusion to the bypass trust; and

b. Allocation of any amount in excess of the applicable exclusion to the marital deduction trust, or distribute such amount outright to the surviving spouse.

2. The goals of the typical AB Trust are to ensure that both spouses' estate tax exemption amounts are fully utilized, while at the same time providing the first decedent spouse the ability to maintain control over the ultimate disposition of the trust property.

ii. Disclaimer Trust

1. A Disclaimer Trust does the reverse of the AB Trust. It provides that at the first death, 100% of the trust assets are allocated to the marital deduction trust, which can continue to be revocable/amendable by the surviving spouse.

2. At the death of the first spouse, the surviving spouse must make the following determinations:

    a. The amount of the combined estates, including trust assets, life insurance, retirement accounts, etc.;

    b. The current applicable exclusion amount; and

    c. The likely applicable exclusion amount at the surviving spouse's death.

3. If the combined estates are less than the current/expected applicable exclusion amount, then the surviving spouse may be comfortable leaving everything in the marital deduction trust.

4. If the combined estates are close to or greater than the applicable exclusion at the survivor's death, the survivor could then disclaim an amount over to a bypass trust for the benefit of the surviving spouse.

5. The goal is for the surviving spouse to determine what amount to disclaim so that the he or she is comfortable that non-disclaimed assets will be within his or her expected applicable exclusion amount.

6. A disclaimer must be filed with the IRS within 9 months from the date of the first spouse's death, and before the disclaimer is filed the surviving spouse must not accept any benefit from the property to be disclaimed.

7. Other considerations to take into account when deciding whether to use the typical AB Trust plan vs. the Disclaimer Trust plan are:

    a. Step-up in basis planning; and

    b. Creditor protection planning.

8. An alternative to a Disclaimer Trust is a Partial QTIP Trust.

iii. Portability. If the value of the first spouse's estate does not require the use all of his or her estate tax exemption, then the amount of the exemption that not used may be used by the surviving spouse if so elected.

III. Irrevocable Trusts

a. General. Upon creation and funding of an irrevocable trust, assets transferred to the trust are typically not included in the grantor's estate and not subject to probate, but the trust cannot be amended or revoked. An irrevocable trust is preferred when the primary goal is to minimize estate taxes and to engage in income tax planning.

b. Non-Tax Planning Trusts

i. Asset Protection Trusts

1. An APT is a self-settled spendthrift trust in which the grantor transfers assets to a trustee but continues to enjoy, to some degree, control and beneficial enjoyment over the trust property.

2. An APT is established in a jurisdiction that has passed laws that are "anti-creditor" and "asset protective" or otherwise permit or foster the creation of APTs.

3. Typically, an APT must have a trustee, usually a corporate trustee, that is domiciled in the chosen jurisdiction.

4. Types of APTs

    a. Domestic Asset Protection Trust

        i. A domestic APT is an APT established under the laws of a state that has passed laws favorable to its creation.

        ii. In 1997, Alaska became the first state to permit the creation of self-settled spendthrift trusts. 13 other states that have since passed APT legislation.

        iii. *Per se* Fraudulent Transfer Rule Cases

            1. *Kilker v. Stillman*[7]

            2. *In re Huber*[8]

            3. *In re Cutuli*[9]

    b. Foreign Asset Protection Trust

        i. An offshore or foreign APT is an APT created under the law of a foreign country that has passed laws favorable to its creation.

[7] 233 Cal. App. 4th 320 (Jan. 16, 2015).
[8] 493 B.R. 798 (Bankr. W.D. Wash. 2013).
[9] No. 11-35256-BKC-AJC, 2013 WL 5236711 (Bankr. S.D. Fla. Sept. 16, 2013).

ii. Possible sites for an offshore APT include Anguilla, Antigua, Bahamas, Barbados, Belize, Bermuda, Cayman Islands, Channel Islands (Jersey and Guernsey) Cook Islands, Cyprus, Gibraltar, Liechtenstein, Marshall Islands, Nevis, Niue, Seychelles, and Turks and Caicos.

iii. The most common reasons offshore trusts are established are to replace or supplement malpractice insurance, reduce asset exposure and discourage lawsuits, enhance a bargaining position when dealing with creditors and avoid or supplement premarital Agreements.[10]

ii. Special Needs Trusts

1. Purpose. A special needs trust is created to hold assets for an individual in order to preserve the government benefits of an individual who is disabled and regularly depends on such benefits.

2. First Party Special Needs Trust

a. Established under 42 U.S.C. § 1396p(d)(4) with assets that are already assets of the beneficiary of the trust prior to the creation of the trust, no matter who creates the trust.

b. The assets may have resulted from an unplanned inheritance, gift, personal injury lawsuit, etc.

[10] Brinker, *Combating Today's Litigious Environment with Offshore Trusts*, 56 Journal of Financial Services Professionals 12 (2002).

c. This type of trust will include a medical assistance payback provision in favor of the applicable state to be effective upon the death of the beneficiary.

3. Third Party Special Needs Trust

   a. This type of special needs trust is not governed by federal statute.

   b. Can be created under the terms of an inter vivos or testamentary trust.

   c. Established with assets that are not owned by the beneficiary of the trust.

   d. This type of trust does not require a payback provision.

iii. Gun Trusts

1. Final Rule 41F (effective July 13, 2016) passed with the goal of ensuring that identification and background checks apply equally to individuals, trusts and legal entities making an application to make or receive an NFA firearm.

2. A gun trust may be revocable or irrevocable, although a revocable trust obviously provides greater flexibility.

3. If the gun trust is irrevocable, or becomes irrevocable upon the death of the grantor, it is advisable to provide for a limited right of amendment to ensure the gun trust stays in compliance with all applicable laws.

4. The main purpose of a gun trust is to pass Title II Firearms down to the next generation in compliance with all laws.

5. Designation of the trustee of a gun trust is very important, and such person or persons cannot be prohibited from owning or possessing firearms.

6. The question most commonly debated by professionals concerning gun trusts is "Who is entitled to possess the firearm?"

c. Gift and Estate Tax Planning with Trusts

i. GST Trust. A trust to which all or a portion of a grantor's generation skipping transfer tax exemption has been allocated, thereby permitting trust assets to be distributed to grandchildren or later generations without incurring either generation skipping transfer or estate taxes on the death of your children of the grantor.

ii. *Crummey* Trust. An irrevocable trust that satisfies the present interest requirement for the annual exclusion, containing specific withdrawal powers given to a beneficiary upon contributions being made to the trust.

iii. 2503(c) Minors Trust. An alternative to a *Crummey* Trust, this type of trust satisfies the present interest requirement for the annual exclusion if it provides that all income and principal shall be distributed to the beneficiary upon the beneficiary attaining the age of twenty-one (21) years, at which time the beneficiary can decide to leave the assets in trust. Discretionary income and principal distributions will be made to the beneficiary prior to attaining the age of twenty-one (21).

iv. Irrevocable Life Insurance Trust (ILIT). This type of trust can be utilized to remove insurance proceeds from being included in the gross estate of an individual. Crummey withdrawal powers are generally incorporated into an ILIT so the ILIT may be funded with annual exclusion gifts to pay premiums.

v. Intentionally Defective Grantor Trust (IDGT). An IDGT may be used to remove an asset's appreciation and/or income from the grantor's gross estate. The strategy typically involves the grantor selling an asset to the IDGT in exchange for a promissory note, thereby freezing the value in the grantor's estate. The grantor will retain a power(s) to qualify the grantor as the owner for income tax purposes but not for gift tax purposes.

d. Charitable Remainder Trusts. A Charitable Remainder Trust ("CRT") is a tax-exempt trust in which the donor, or a beneficiary designated by the donor, retains the right to receive an income stream for life or for a fixed number of years (up to 20 years).

i. A CRT can be created during life or at death in a will or trust.

ii. A CRT is an excellent vehicle for a person without descendants.

iii. There are two types of CRTs: (1) Charitable Remainder Unitrust ("CRUT") and (2) Charitable Remainder Annuity Trust ("CRAT").

1. Charitable Remainder Unitrust (CRUT).

a. The payout received by the donor is a fixed percentage of the value of CRT assets, determined annually. The minimum permissible payout is 5%. The maximum payout is limited by the "10% Remainder Rule".

b. IRS guidelines provide that the projected value of the charitable remainder must be at least 10% of the value of the assets contributed to the CRUT. The payout rate varies inversely with the value of the charitable remainder. In other words, the higher the payout rate, the lower the value of the charitable remainder.

2. Charitable Remainder Annuity Trust (CRAT).

    a. The CRAT is distinguished from the CRUT by two significant characteristics:

        i. First, the payout received from the CRAT by the donor is a fixed dollar amount, determined when the CRAT is initially funded. The payout amount will not fluctuate, irrespective of investment performance, for so long as the CRAT has sufficient principal to fund the payout. Thus, the payout will not decrease if the CRAT has poor investment performance in a particular year, nor will it increase as a result of good investment performance.

        ii. Second, after the CRAT is initially funded, additional contributions may not be made (although the client may establish one or more separate CRATs). With the CRUT, the client can make additional contributions.