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For Trusted Advisors

NEW YORK LIFE

Adding flexibility to irrevocable trusts can help address tax law uncertainty.

By David R. Toups, JD, MBA, CFA®, CFP®, CTFA

Attorneys across the country are rapidly drafting irrevocable trusts for a multitude of clients who are anxious to capture the increased estate and gift tax exclusion amounts provided in the Tax Cuts and Jobs Act (TCJA). As enacted, the TCJA sunsets on its own at the end of 2025; however, due to ever-shifting political winds, these increased exemptions may be terminated much sooner—possibly even in 2021 or 2022, depending on the ultimate results of the November 2020 election cycle.

In the event changes or modifications are needed to any hastily created trusts that miss or misstate some provision, judicial reformation may be costly and may not always achieve the full extent of the change needed, especially if a not-so-loved one decides to oppose it for some concession or advantage.

In addition, upon the sunset or earlier repeal of the TCJA, the ability to gift approximately $5 million to others without gift taxes will vanish, and if later taxed, the estate will bear (assuming no additional asset appreciation) a $2 million tax bill at the current federal estate tax rate.

Since attorneys' schedules are filling up in anticipation of eventual repeal, this article is provided to describe some helpful provisions that can be added to irrevocable trusts to provide greater flexibility in relation to anticipated changes in the law.

Trust protector provisions

The first of the suggested provisions that may assist grantors to achieve the irrevocable trust's purpose are trust protector provisions. Trust protector provisions create a non-fiduciary office or role for an independent third-party, preferably with legal and business acumen, that typically would require a judge in a court of law to perform. Just as parties to a contract may opt to subject the agreement to arbitration or mediation, in essence choosing their own dispute resolution mechanism, a trust protector may serve a similar role by determining if and how a trust may be amended or modified to achieve its stated purposes. The trust protector may act as a failsafe mechanism, providing an independent party to change the trust's situs or terms to address unexpected changes that inevitably come to pass after an irrevocable trust is executed and administered.

Decanting the trust

A second suggested provision is to grant either the trustee or trust protector authority to follow any appropriate decanting statute to transfer assets from the existing trust into a newly formed successor trust. Such provisions may be exceedingly important as the trust ages. Anyone who has administered or been a beneficiary under a trust drafted before major tax law revisions existed will readily understand the importance of such a provision.

An irrevocable trust may easily exist for fifty years or longer while changes naturally occur in tax and trust laws, product developments in financial instruments and services, long-term economic cycle fluctuations, and sociopolitical environments.

As the trust ages, there eventually may come a point that administration under the trust's antiquated language becomes impossible or unbearable. By invoking such statutory decanting provisions, the trustee or trust protector could transfer the trust assets into an updated trust with language specifically addressing the unforeseen changes or events that could have adverse effects on the trust's taxation, assets, or beneficiaries.

Powers of appointment

Third, powers of appointment may permit trust beneficiaries to direct their trust assets during their life or at their death to charity, to anyone in general, or to a narrowly defined class of people. The power of appointment provides the beneficiaries the ability to direct the trust assets directly to beneficiaries outright or on certain conditions, or indirectly to them by directing assets into updated and legally current trusts for remaining loved ones, similar to the decanting provisions referenced above.

Even when the aging trust contains provisions that would retain the assets in trusts for the intended successor beneficiary, consideration should be given to utilize an available power of appointment to direct assets into an updated trust based upon current tax and trust laws and contemporary trust planning strategies.

Reciprocal trusts

Finally, for spouses contemplating using their current $11.58 million life-time gift tax exemption by creating irrevocable trusts for one another, a note of caution: Beware of the reciprocal trust doctrine. If the net result of the two nearly identical trusts created in close proximity to one another leaves the parties in the same or a substantially similar position as before the trusts were created, the trusts will be disregarded, and each spouse will be deemed a grantor of the other's trust—making the gifts pointless from an estate tax perspective.

Trust differentiating strategies do exist to counter such a characterization and attorneys familiar with this area of the law should utilize them.

Conclusion

Whether the TCJA sunsets in 2025 or is repealed earlier, it's time for clients to have a conversation with their trusted legal or tax advisors about existing estate planning opportunities and strategies that may vanish very soon.

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Estate Planning

Situs an irrevocable trust in a different jurisdiction for additional benefits.

By Steven J. Oshins, Esq., AEP® (Distinguished)

Most estate planners automatically situs — which is Latin for position or site — their clients' irrevocable trusts in the jurisdiction in which the client resides without considering the possibility of using a different jurisdiction. This is often done for no reason other than the fact that it is customary to do so. However, in many situations, this decision causes a loss of potential benefits that may have been obtained by exploring the use of a different trust situs.

Common reasons to situs a trust in a different jurisdiction

STATE INCOME TAX SAVINGS. There is almost never a good reason to maintain a non-grantor irrevocable trust in a jurisdiction that has a state income tax on trusts. Such trusts should almost always be moved to a state that has no fiduciary state income tax on undistributed income. This is especially important when a lot of the trust income will not be distributed to the beneficiaries either because the beneficiaries are in a high income tax bracket, where the beneficiaries should not receive large distributions, and/or the beneficiaries have creditor issues and therefore should not receive large distributions for that reason.

Different states tax trusts based on different factors. Some states tax the trust based solely on the residency of the settlor or testator. Other states tax a trust based solely on the residency of a trustee or on the place of administration. Other states tax a trust based on the residency of a beneficiary, although this has been held to be unconstitutional in at least one case involving a fully discretionary trust. Other states tax a trust based on two or more factors. Therefore, it is necessary for the advisors to be aware of the residency of the parties to a trust in order to do the planning.

CREDITOR PROTECTION. Many trusts are drafted to give the trustee the power to make distributions to the beneficiaries for their health, education, maintenance and support. These trusts are often called "support trusts" for creditor purposes. Depending upon state statutes and case law, support trusts are often available to certain classes of creditors, most notably including divorcing spouses. A discretionary trust, on the other hand, gives the trustee absolute discretion over distributions and thus generally protects the assets from a broader range of creditors. (An exception is the 2013 Florida case, *Berlinger v. Casselberry*, where the Court ruled that even a discretionary trust domiciled in Florida is subject to a writ of garnishment for unpaid alimony.) However, when the trust has been drafted as a support trust, it is imperative that the trust be domiciled in a state that protects the trust assets from various exception creditors.

DECANTING. Currently, more than half of jurisdictions have decanting statutes. A decanting statute may allow the distribution trustee to distribute the trust assets into a different trust with different provisions for one or more of the beneficiaries of the prior trust. This flexibility can become very important when there is a drafting error, a change of circumstances, or an enhancement that the family would like built into the trust. The failure to consider using one of these jurisdictions (or at least allowing the trustee or trust protector to move the trust to a favorable decanting jurisdiction) could mean that the desired changes cannot be made. (Note that trust modification strategies other than decanting might also be an option in some circumstances).

Although decanting has traditionally been used more to fix drafting errors, the sophisticated estate planner will also decant a trust in order to save taxes and/or to protect assets from creditors and divorcing spouses.

DOMESTIC ASSET PROTECTION TRUSTS. Domestic asset protection trusts have become one of the most popular and widely used asset protection techniques. Only a handful of jurisdictions have favorable statutes allowing the settlor to set up a domestic asset protection trust. Although many attorneys are taking advantage of this, many others are not. Some have failed to use this technique because of the uncertainty about whether it will work. This is often based upon a misunderstanding about the objectives of an asset protection structure. The goal is to put the client into a better position than the client was in without the structure. Thus, there will not be a 100% success rate, but, this technique may help the client negotiate a favorable settlement or scare the creditor away altogether.

For a resident of a jurisdiction that does not have a domestic asset protection trust statute, the hybrid domestic asset protection trust may be used because it greatly enhances the likelihood that the trust assets will be protected if challenged in court and it should significantly reduce the settlement number in a negotiation.

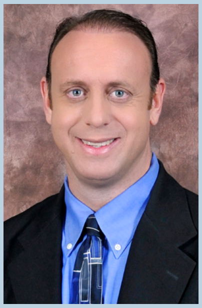
The hybrid domestic asset protection trust is a third-party trust where the settlor isn't a beneficiary but can be added as a beneficiary at a later date through the appointment of a trust protector. There is almost never a reason to actually add the settlor as a beneficiary if designed properly. As long as the settlor isn't added as a beneficiary, the trust is simply a third-party trust, generally protected from a creditor of the settlor.

DYNASTY TRUSTS. Dynasty trusts aren't just estate tax savings vehicles. They also are used to provide asset protection and divorce protection for the beneficiaries for as many generations as applicable state law allows. Just as attorneys should use lifetime trusts to protect assets from estate taxes, creditors, and divorcing spouses for the first generation, the same concepts apply to more remote generations as well.

There is no reason not to protect the assets for grandchildren, great-grandchildren, and other beneficiaries. Thus, it is important for the planners and clients to consider situsing the irrevocable trust in a state with a strong dynasty trust statute.

Conclusion

There are many reasons not to simply use the local state trust laws. Just because nearly every estate planner relies solely on the client's local state laws does not mean that the more advanced estate planner should follow suit. It can cost the client's family a significant amount of money in unnecessary taxes, expose assets to creditors and divorcing spouses that could easily have been avoided, and cause the family to miss opportunities for enhanced flexibility.



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Life Insurance Planning

Why employer-provided life insurance may fall short.

By Eva Stark, JD, LL.M.

Many people, especially younger individuals or those with convenient access to employer-provided group term life insurance, may rely solely on such insurance for their protection needs.

Reliance exclusively on employer-provided life insurance to meet one's specific needs and circumstances, however, can be risky for a variety of reasons:

- The benefit amount may be too low;
- Coverage is typically lost with an employment change; and
- The cost of coverage may be higher than could be obtained on an individual basis.

COVERAGE AMOUNTS MAY BE TOO LOW. Many employers provide group term insurance to their employees as an employee benefit, but the amount of coverage provided varies greatly by employer and may be insufficient for individual needs. Employers may provide policies with a fixed death benefit amount to each employee, such as $50,000, or they may provide coverage based on a multiple of the employee's salary, such as a death benefit equal to one, three or five times an employee's annual compensation.

Depending on individual circumstances, such one-size-fits-all group term insurance may or may not be enough. While a group policy may be sufficient for a single person with no dependents, it may be woefully insufficient for a primary income earner with a stay-at-home spouse, parents with dependent children, and/or individuals with disabled family members or elderly parents to support.

COVERAGE MAY BE EASILY LOST. Employer-provided term coverage may be easily lost if employment stops, which can happen involuntarily (e.g., a reduction in work force or termination by the employer), voluntarily (the employee changing jobs), or upon retirement. A job loss or job change may therefore leave a family with no protection in the event of a premature death.

Even if new employment is found quickly, the new employer may provide substantially less coverage than the previous employer (or no coverage at all). This could leave an employee scrambling to obtain additional insurance that he or she previously assumed could be relied upon. The additional insurance need also may arise after a change in the employee's health, which could make obtaining additional coverage more difficult, more costly, or simply not possible, depending on the specific health issue.

COSTS MAY BE TOO HIGH. Some people also may be overpaying for employer-provided life insurance. While employer-provided life insurance can be convenient and often does not require a medical exam (and some coverage may even be provided at no cost to the employee), the convenience of employer-provided life insurance can also come at a cost in some cases. After all, group term insurance must cover every employee, regardless of age or health status. This could mean that some employees, especially those who are younger, healthier, or non-smokers, could pay less for the same or more coverage by obtaining individual life insurance.

Coverage Amount Considerations

To determine the amount of coverage that should be considered, it will be important to analyze an individual's financial circumstances and goals. For example, consider:

- How much cash would the family need if a death occurred to pay medical costs, funeral expenses, or estate administration costs?
- What outstanding debts does the individual have (e.g., mortgages, auto loans, credit card balances)?
- Does the individual intend to provide for his or her children's educations? How large of an education fund would be needed?
- How much will be needed to support the surviving spouse in his or her accustomed manner of living? Will the survivor seek employment, and if so, how much will he or she earn? For how long will he or she continue to work? When is he or she hoping to retire?
- For how long is coverage needed? Ten years? Twenty years? Permanently?
- Are there other assets or income sources that could continue to provide support for survivors after the main breadwinner's death (e.g., rental income, dividends, pensions, etc.)?

The Solution

The loss of a loved one is extremely difficult even without the financial problems that tend to follow. Having enough coverage can ensure that debt levels remain manageable and that lifestyles or children's educations are not compromised if the unthinkable happens.

An insurance or financial professional can help evaluate whether employer-provided life insurance is sufficient and whether individual life insurance might make sense in addition to or in lieu of employer-provided insurance.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.