Trust planning for business owners

By Jeff Chadwick, JD

As an estate planning attorney, the first statement I frequently hear from potential clients is, "I need to get a trust in place." Many clients, however, are not sure exactly why they need a trust or what type of trust is best for them. This article provides a basic overview of common trust structures with a particular focus on trust planning for business owners, and while it should serve as a good foundation, it does not attempt to explain all trusts. Clients should seek the advice of competent legal counsel to help analyze their individual needs.

Common trust planning goals

To move a conversation with a potential client forward, I normally ask, "Why do you need to get a trust in place? What are you aiming to accomplish?" Answers vary but some common client responses are:

- "We just need a basic estate plan and hear a trust is the way to go."
- "My mom is getting older. I need to help her with her finances, and we also want to avoid probate when she dies."
- "Privacy is a concern. We don't want anyone knowing our business."
- "We have worked very hard to build our wealth and we need a trust to protect it."
- "Our daughter just got married and we don't trust her husband."
- "We need to reduce taxes."
- "We need to come up with a plan to transition our business to the next generation."

The good news is that a trust can help address all of these objectives. The bad news, as is often the case when dealing with lawyers, is that the right type of trust depends on the client's unique circumstances.

Revocable trusts vs. irrevocable trusts

A threshold question is whether a client needs a "revocable" trust or an "irrevocable" trust. As their names imply, in most cases, a client can modify or terminate a revocable trust during lifetime, while a client cannot modify or terminate an irrevocable trust after it is formed. These basic features produce different legal consequences, making revocable trusts suitable vehicles to accomplish some, but not all, common client objectives. Similarly, irrevocable trusts are the right choice in certain situations, but may be too much horsepower in other situations.

Revocable trusts work best to accomplish basic estate planning goals such as managing property during lifetime and controlling the disposition of assets upon death. Perhaps the biggest misconception surrounding revocable trusts, however, is that they provide clients with extra asset protection. That is simply not the case. When a client transfers assets to a revocable trust, generally the client can still withdraw or use the trust assets at any time. Because there are no restrictions on a client's ability to control and benefit from assets held by the revocable trust, there are also no restrictions on a creditor's ability to access those same trust assets to satisfy a judgment.

The same is true for federal estate tax purposes where a client is deemed to own all assets held by a revocable trust at death, thereby eliminating any potential estate tax savings.

Due to the limitations associated with revocable trusts, clients tend to form irrevocable trusts for specific purposes, the most common of which are to increase asset protection and minimize taxes. When a client transfers an asset to an irrevocable trust, the transfer is typically permanent and the client cannot recover the asset or otherwise change the terms of the trust agreement. Consequently, more care is often required when assisting clients with the design and funding of irrevocable trusts.

Revocable trust strategies

Structuring "core" estate plans

A client's "core" estate plan includes documents that govern the disposition of the client's assets upon death. Clients can generally choose between a "standalone" will or a "pour over" will and revocable trust, also called a "living" trust. We almost always recommend that clients utilize a revocable trust due to the following advantages:

- **Privacy.** A standalone will contains all of the substantive provisions regarding the disposition of a client's assets upon the client's death. Because most wills become a matter of public record upon death, the inclusion of dispositive provisions within a client's estate plan in a will reveals potentially sensitive information to the public. By contrast, a pour over will simply provides that a client's assets will be distributed to the client's revocable trust upon death. The revocable trust agreement contains the substantive provisions of the client's estate plan. Although the client's will may be filed with the probate court upon death, the revocable trust will not be filed, which prevents the client's estate plan from becoming a public record. Many business owners are prominent local or national figures who place great value on their family's privacy. For this reason alone, most business owners prefer a revocable trust over a standalone will when presented with both options.
- **Incapacity management.** If a client becomes incapacitated, a successor trustee can step in to manage the client's financial affairs, thereby avoiding the costs and inconvenience of having a court-appointed guardian. While financial powers of attorney can serve a similar purpose, many financial institutions and third parties prefer to work with trustees instead of agents acting under a power of attorney. This is particularly important for business owners, as the business interruption and

financial hardship caused by an owner operator's incapacity can be severe.

- **Probate avoidance.** If a client fully funds his revocable trust by retitling all property in the name of the revocable trust or otherwise naming the revocable trust as payable-on-death beneficiary, then the client can avoid the probate process entirely. This means that the probate court would not be involved in the administration of the client's estate and the client's assets would not be listed on an inventory that under certain circumstances must be filed in the probate court and made a matter of public record. Even if a client does not elect to fully fund his revocable trust, transferring selected assets to the revocable trust before death can be beneficial. For example, if a client owns real property in a state other than the client's domicile, the client should consider transferring such real property to his revocable trust to avoid the probate process in such state(s) and the related costs and attorneys' fees. Business owners may also prefer to transfer all ownership interests in their businesses to their revocable trust during lifetime. That way, upon the business owner's death, a successor trustee can begin acting immediately without needing to wait on the court to admit the business owner's will to probate and appoint an executor. Courts vary in their speed and efficiency, but it can often take weeks, if not months, after a business owner's death to schedule a probate hearing.
- **Administrative simplicity.** A client can amend a revocable trust without going through the formalities required for changing a will, making it easier to revise her estate plan over time. In addition, once a revocable trust is fully funded, the client simply needs to amend the revocable trust agreement to update her estate plan, rather than changing all applicable beneficiary designations. The revocable trust, therefore, acts as a

funnel to collect and distribute assets at death in an orderly manner.

Facilitating anonymous ownership of assets

Revocable trusts also are useful tools when a client desires to own a particular asset, such as a personal residence, anonymously. Rather than acquiring the home or other asset in the client's individual name, the client can take title in the name of a revocable trust. The client should select an inconspicuous name for the revocable trust given that the homeowner's name is often publicly available through online real property records. The client should also select a third-party trustee who is not easily linked to the client given that deeds are also public records. Most states permit revocable trusts to qualify for the homestead exemption so long as the trust agreement contains certain required provisions, which often makes revocable trusts the preferred ownership structure for primary residences compared to a business entity such as a limited liability company. The client retains the right to revoke the trust at any time and also change trustees, thereby giving the client functional control over and access to the trust. At the client's death, the remaining trust assets typically flow into the client's core estate plan to be distributed as provided therein.

Irrevocable trust strategies

Increasing asset protection

Asset protection, an increasingly common estate planning objective, is remarkably easy to achieve. Clients just need to give all of their money away to other people in advance of any potential creditor issues. Most clients, of course, are unwilling to do this. As stated above, clients may be under the false impression that transferring assets to a revocable trust protects such assets from their creditors. Only an irrevocable trust, however, offers any asset protection benefits.

There are two types of irrevocable asset protection trusts, third-party "spendthrift" trusts and "self-settled" asset protection trusts.

A spendthrift trust is a trust created by the client for the benefit of one or more third parties, such as the client's spouse, descendants, or other individuals. The irrevocable trust agreement typically authorizes, but does not require, distributions of income and principal within the discretion of the trustee, and prohibits the beneficiary from transferring or pledging the beneficiary's interest either voluntarily or involuntarily. Because the irrevocable trust owns the assets (and not the beneficiary) under this arrangement, the trust assets should not be available to the beneficiary's creditors. Third-party spendthrift trusts can be particularly useful for business owners or other high liability professionals, such as doctors, whose professional activities may subject them to regular threats of litigation. Many clients also incorporate this concept into their core estate plan, which waits to fund irrevocable trusts for the benefit of surviving spouses and descendants upon the client's death.

While some clients are willing to fund an irrevocable trust for third parties during lifetime, other clients seek to have their cake and eat it too by achieving asset protection while also retaining the right to receive discretionary distributions from

the trustee. Historically, these self-settled asset protection trusts were only available in offshore jurisdictions. In recent years, however, a number of states, including Delaware, Nevada, South Dakota, and others, have adopted legislation authorizing the use of domestic asset protection trusts or "DAPTs." A DAPT is typically structured as an irrevocable trust with a third-party or professional trustee who is appointed to manage and distribute the trust assets. Depending on the structure of the DAPT, the trust assets may or may not be subject to estate tax at the client's death. Notably, while DAPTs certainly seem attractive, they may not be bulletproof and clients should understand the potential risks associated with any DAPT structure before proceeding.

Minimizing income taxes

In addition to enhanced asset protection, irrevocable trusts also can help clients seeking to minimize income taxes. Clients who live in a state that imposes a high state income tax, such as Hawaii, California, or New York, may wish to create an irrevocable non-grantor trust, or "ING Trust," in a jurisdiction that does not impose a state income tax like Delaware, Nevada, or Wyoming. To form an ING Trust, a client generally transfers assets to a non-grantor trust (i.e., a separate taxpayer) in a state that does not impose a state income tax and authorizes DAPTs. Most gifts are designed to be complete for income tax purposes, but incomplete for transfer tax purposes, meaning that the assets of the ING Trust should still be included in the client's taxable estate upon death. Because the ING Trust is a separate taxpayer, however, it may enable a client to minimize state income tax on passive investments. The challenge, of course, can be attempting to distribute earnings back to the client if the client continues to reside in a high income-tax state.

In unique situations, irrevocable trusts can also help clients minimize federal income taxes. One common scenario involves a business owner or other investor who owns stock in a C corporation held for five years or more. So long as certain requirements are met, this stock may be treated as qualified small business stock (QSBS). Under Section 1202 of the Internal Revenue Code, taxpayers may generally exclude up to $10 million of capital gain from the sale of QSBS to a third party. Although only one QSBS exclusion is available per taxpayer, a client may consider giving stock to one or more non-grantor trusts in order to "stack" QSBS exclusions and minimize total capital gain among family members. For many business owners, the harshness of giving away their stock is mitigated by the resulting income tax savings.

Minimizing federal transfer taxes

Finally, irrevocable trusts are often the weapon of choice for wealthy families attempting to minimize federal transfer taxes as assets pass from generation to generation. In 2025, each taxpayer has a $13.99 million exemption ($27.98 million per married couple) from federal gift and estate tax, indexed for inflation and reduced by any exemption used in prior years. Gifts during life or bequests at death that exceed a taxpayer's exemption are subject to a 40% gift or estate tax, although there are unlimited deductions for transfers to spouses or charity. There are similar rules associated with the federal generation skipping transfer (GST) tax, which applies

when a transfer is made to an individual who is two or more generations below the transferor, such as a grandchild.

If a client's net worth is likely to exceed the available exemption at death, and such client wishes to pass wealth down to descendants or other beneficiaries (besides spouses and charities), it is appropriate to view the IRS as a "40% silent partner" in the growth of family assets. In other words, for every additional dollar a wealthy client earns, the IRS is standing to inherit forty cents when assets pass to the next generation. Moreover, even though federal exemption amounts are at an all-time high, under current law these exemption amounts are only effective for transfers made and clients passing away through 2025. In 2026, the exemption amounts are set to decrease by 50%, unless the Trump tax cuts are extended.

There are many different types of irrevocable trusts available to reduce federal transfer taxes, and it would be impossible to discuss them all within this article. Many wealthy families, however, create and fund intentionally defective irrevocable trusts, or IDITs, for the benefit of family members and other preferred beneficiaries. An IDIT refers to an irrevocable "grantor trust" in which the grantor (or creator) of the trust is treated as the owner of the trust assets for federal income tax purposes, but not federal estate tax purposes. This dissonance should enable a client to transfer appreciating assets, such as a family business, to an IDIT during lifetime without income tax consequences, while also shielding the IDIT assets, plus all future appreciation, from federal transfer taxes upon death. In addition to reducing federal transfer tax exposure, an IDIT also should increase asset protection during lifetime. IDITs are popular vehicles to own life insurance (through so-called irrevocable life insurance trusts or ILITs), particularly because the death benefit would otherwise be included in a client's estate tax base, even if it were not subject to income tax.

IDITs can be structured in a number of different ways, but the two most common alternatives are an IDIT for the benefit of descendants or other preferred beneficiaries only (a descendants' trust) or a spousal lifetime access trust (a SLAT). A descendants' trust only permits distributions to children, grandchildren, and other preferred beneficiaries, while a SLAT permits distributions to a spouse, oftentimes in addition to descendants.

Conceptually, these two types of IDITs are very similar, except that SLATs provide more potential access to the gifted assets by naming the non-grantor spouse as a beneficiary. As a result, SLATs are often preferred, and spouses will often create two SLATs, one for the benefit of each spouse. Importantly, though, the SLATs must be structured differently to avoid the "reciprocal trust doctrine," which could subject the assets in both SLATs to estate tax (the exact result sought to be avoided).

Transfers to IDITs also can be structured in a number of different ways. The two most common transfer techniques, which are especially popular with business owners, are gifts and installment sales. Both strategies are designed to remove appreciating assets from the federal transfer tax system, and in many instances, an initial seed gift is made, followed by an additional sale of assets. In both cases, the transfer should "freeze" the value of an asset for transfer tax purposes

at its value on the date of the transfer, with any future appreciation avoiding estate tax. Furthermore, with the right asset, exemptions can be "leveraged" through certain valuation discounts. For example, the fair market value of a closely held business interest may include discounts for a lack of marketability and lack of control, which can often range from 20% to 40% of net asset liquidation value.

When a gift is made to an IDIT, the gift consumes all or a portion of a client's remaining exemption. By contrast, when an asset is sold to an IDIT in exchange for a promissory note with a face amount equal to the fair market value of such asset, this should not be a gift because the IDIT should be providing full and adequate consideration for the asset it received. Promissory notes in this context should bear a market rate of interest, permit prepayments of interest and principal, and mature within the holder's life expectancy. Installment sales, compared to gifts, can be helpful when a client, such as a business owner seeking to exit the business, wishes to preserve some cash flow from the transferred assets or has no exemption remaining to cover an additional transfer. A transfer also can be structured as an installment sale initially, but a taxable gift can be made at a later date by canceling all or a portion of the note. This strategy could be particularly appealing with the uncertainty surrounding the exemption levels heading into the next election cycle and 2026.

Conclusion

Although many clients "need to get a trust in place," the right trust depends on each client's individual goals and circumstances. The easiest place to start is identifying whether a client's needs require a revocable trust or an irrevocable trust. Revocable trusts are most often used to accomplish a client's basic estate planning or privacy objectives, including as the central component of the client's core estate plan. Irrevocable trusts, meanwhile, offer asset protection benefits and tax savings that are unavailable with a revocable trust structure. It is important for clients and their advisors to be familiar with available trust structures in order to best carry out their objectives.

About the author.

Jeff Chadwick, JD, is a shareholder with Winstead, PC, and the chair of the wealth preservation practice group. Jeff focuses his practice on trust and estate planning for business owners, corporate executives, professional athletes, and other high net worth individuals and families. He strives to provide innovative and practical solutions to a wide range of legal matters, including wealth transfer planning, trust and estate administration, business formation and succession, asset protection, charitable giving, and premarital planning. Jeff is board certified in estate planning and probate law by the Texas Board of Legal Specialization.

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