

Uses of Trusts in Family Estate Planning in the US

**David M. English
University of Missouri
Reporter, Uniform Trust Code**

The trust is used by families to transfer wealth to the next generation. But the trust has many other uses. These include avoiding the probate process at death, avoiding the need to appoint a guardian for the settlor or beneficiary, minimizing the risk of creditor claims, qualifying the settlor or beneficiary for government welfare benefits, and reducing estate and gift taxes that would otherwise be payable. What follows are descriptions of eight current uses of trusts in family estate planning.

1. To avoid probate

At an individual's death, property titled in an individual's name must go through what is usually referred to as "probate." Probate is a judicial process whereby title to the decedent's property is transferred to the beneficiaries under the will, if there is a will, or to the heirs if the decedent did not make a will. To begin probate, a petition must be filed with the court to approve the will and the court or designated court employee must appoint a personal representative to manage the estate. The personal representative will then (1) determine the decedent's assets and file an inventory with the court, (2) publish notice to creditors and pay creditor claims, and (3) file a final accounting with the court when administration is concluded.

In many states, probate is a cumbersome and time consuming process. In other states, including states that have adopted the Uniform Probate Code, much less paperwork is required. The desire to avoid probate is the number one reason in the US why individuals create trusts. The trusts that are created to avoid probate are nearly always revocable. A majority of these revocable trusts are self-declarations of trust in which the settlor is appointed as initial trustee. Key to the success of these trusts is an effective provision appointing a successor trustee upon the initial trustee's death or earlier incapacity. That way, continuous management can be assured.

During the settlor's lifetime, distributions from the revocable trust are usually within the settlor's control. The trust document should anticipate that the settlor will become incapacitated, in which case the trustee should be given discretion to make distributions for the settlor's benefit. The trust will usually terminate at the settlor's death and distribution will then be made outright to the beneficiaries. Sometimes, a portion or all of the assets will continue in trust for one of the other reasons mentioned below.

2. To avoid guardianship for settlor

Many individuals lack mental capacity to make their own decisions during at least some portion of their lives. When an individual lacks capacity and a decision with respect to the person's

property must be made, the traditional remedy is for the court to appoint a conservator or guardian of the estate. Requesting the appointment of a guardian or conservator requires proof of the person's incapacity and may involve considerable expense. It is not a step desired by most families but becomes a necessity when other methods for making the decision are no longer available.

Over the past few decades, planning to avoid guardianship or conservatorship has become a standard part of the estate planning process. Typically, an individual will sign two powers of attorney, one for health care and one for property management. But the individual will often also sign a revocable trust. The revocable trust is intended to avoid the need for a guardian or conservator because the individual's assets will be retitled in the name of the trustee and will be managed by the trustee. But if the settlor is the initial trustee, the trust will work only if the trust document has an effective provision for removing an incapacitated trustee from office and appointing a successor trustee.

The trustee's authority extends only to the assets actually retitled into the trustee's name. If the settlor fails to transfer all of the settlor's individually owned assets into the trust, probate will not be avoided, and it may be necessary to appoint a guardian or conservator to manage the property not placed into the trust. To avoid this possibility, it is a good practice to grant an agent under a power of attorney the authority to transfer the principal's assets into the principal's revocable trust.

3. To avoid guardianship for a minor

Children under age 18 lack legal capacity to manage property. Should a minor child inherit significant assets, it may be necessary for the court to appoint a conservator or guardian of the estate to manage the minor's property. To avoid this need, the creation of a trust for the benefit of minor children is usually recommended.

A guardianship or conservatorship for a minor terminates when the minor reaches age 18. Many if not most parents believe that an 18 year-old child is not yet capable of managing significant property. The advantage of creating a trust is that the parent may specify any age for trust termination. It is rare that a parent would provide that the child's trust terminate prior to age 25.

4. To protect an adult beneficiary

Trusts are frequently created for adult beneficiaries. Sometimes, the trust is created because the adult beneficiary lacks mental capacity and the trust will avoid the need for guardianship or conservatorship. But trusts are also created for beneficiaries who have legal capacity but whom the settlor believes lack the *actual* capacity to manage significant assets. Such trusts often grant the trustee discretion as to when distributions are to be made although some require that the beneficiary receive all of the income. Such trusts, and nearly all other trusts in the US for that matter, also contain a spendthrift provision. A spendthrift provision prohibits a beneficiary from selling the beneficiary's interest in the trust and prohibits a beneficiary's creditor from collecting payment from the trustee. Spendthrift provisions are valid in all US states but many states provide that a spendthrift

provision is ineffective to bar a claim for child or spousal support.

5. To qualify for government welfare benefits

Trusts are frequently created to qualify a beneficiary for government welfare programs, the principal programs being Medicaid, which pays for health care, and Supplemental Security Income (SSI), which provides a monthly cash payment. To qualify for such benefits, an individual must usually have less than \$2,000 in "available" resources. The challenge is to draft the trust in such a way that the trust will not count as a resource but distributions can still be made to pay for items not paid for by the government program.

In the case of trusts established by a third party such as a parent, the beneficiary's interest is treated as an available resource if the beneficiary under state trust law "has the legal ability to make such sum available for support and maintenance." 45 C.F.R. § 233.20(a)(3)(ii)(D). In other words, if the beneficiary has the legal right to compel a distribution, then the trust is treated as the beneficiary's resource and the beneficiary is ineligible for Medicaid or SSI. The case law in the states is not consistent but generally the more discretionary the beneficiary's interest the less likely it is that the beneficiary can compel a distribution and the more likely it is that the beneficiary will qualify for Medicaid or SSI.

If an individual creates a trust for the individual's own benefit, or if someone else creates a trust with the individual's funds, the rules are less favorable. Any trust property that *could* in the exercise of the trustee's discretion be distributed to the beneficiary will be treated as an available resource for Medicaid purposes. Consequently, if the trustee has discretion to distribute income or principal to the beneficiary, the entire trust will be considered an available resource even if the trustee never makes a distribution. But federal law recognizes some important exceptions, one of which is referred to as a (d)(4)(A) trust. A (d)(4)(A) trust is created using the assets of a disabled person under age 65. To assure eligibility for government programs, the trust must have a "pay back" provision under which the state government will receive all amounts remaining in the trust upon the death of such individual up to the amount of Medicaid benefits paid. 42 U.S.C. § 1396p(d)(4)(A)

6. To reduce federal estate and gift tax

The US transfer tax system is very favorable compared to the systems in many other countries. In 2012, no gift tax is due unless lifetime taxable gifts exceed \$5,120,000. Similarly, no estate tax is due unless the taxable estate at death, when combined with lifetime taxable gifts, exceeds \$5,120,000. Despite these high levels of exemption, numerous techniques exist whereby the very wealthy may reduce or even eliminate the estate or gift tax. Many of these techniques involve the use of trusts. The following are some examples:

Annual Exclusion Trusts. An individual may make gifts of up to \$13,000 per year to any other person without any of the transfer counting as a "taxable" gift. Furthermore, because the donor no longer owns the gifted property, estate tax at death is also reduced. Annual exclusion gifts may

be made outright but are often made in trust, particularly if the donee is a minor, is disabled, or the donor otherwise believes the donee lacks the ability to manage the gift.

Irrevocable Life Insurance Trusts. Life insurance is frequently used to pay death-related expenses. But if the decedent owns the policy until death, the proceeds of the policy will be subject to estate tax and a substantial portion of the proceeds will be needed to pay the extra tax caused by the taxation of the life insurance. This increased tax can be avoided if an irrevocable life insurance trust is created and the trustee purchases the insurance. Tax is also avoided if the decedent transfers life insurance to the trustee as long as the insured survives for at least three years.

Marital Deduction Trusts. Estate and gift tax can be deferred if property is transferred to the spouse. The theory here is that tax will be collected, if at all, at the surviving spouse's death. Transfers made outright to the spouse qualify for the marital deduction but trusts are also frequently used.

7. To control who will eventually receive the property

Divorce and remarriage is common in the US. Frequently, a decedent is survived by a second spouse and by children of a prior marriage. Oftentimes, the surviving spouse also has children of a prior marriage. If the decedent leaves the decedent's estate outright to the surviving spouse, there may be a concern that the spouse will subsequently leave the property to the spouse's children, thereby disinheriting the decedent's children. By creating a trust for the spouse, the decedent can provide for the spouse's needs during the spouse's lifetime while still assuring that the assets will pass to the decedent's children at the surviving spouse's death.

8. To protect against claims of the settlor's creditors

Traditionally, a settlor could not be a beneficiary of a trust and at the same time shield assets of the trust from claims of the settlor's creditors. Any trust property that *could* in the exercise of the trustee's discretion be distributed to the settlor-beneficiary is subject to the claims of the settlor's creditors. But beginning with Alaska in 1997, about a dozen US states have enacted what are known as Domestic Asset Protection Trust (DAPT) statutes. A DAPT normally involves the appointment of a trust bank in the applicable state to act as trustee. If the other requirements of the particular state statute are met, the settlor-beneficiary may be eligible to receive discretionary distributions from the trust without the settlor's creditors being able to reach the settlor's beneficial interest.