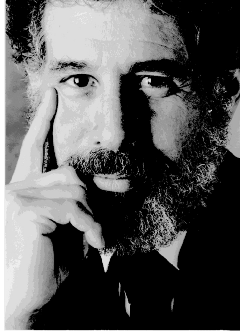

Leimberg's Think About It

A Digest of the Legal News of the Past Month That Will Affect Your Sales and Service in the Future

Think About It is written and edited by Stephan R. Leimberg, JD, CLU

WHY YOU MAY NEED A TRUST:

The comments that follow are an excerpt from the soon to be released 3rd edition of The **NEW, NEW BOOK OF TRUSTS** (610 924 0515). Our thanks to attorneys (and my co-authors) Charles K. Plotnick and Daniel B. Evans for allowing us to share this most useful information. You have Steve Leimberg's permission to reproduce and share this freely with clients and prospective clients.

Inability, Disability, Creditors, and Predators!
There is no better tool to help handle all these problems than a trust!

Keep reading and you'll find out:

- Why so many of us need trusts
- How can a trust help you personally
- When you should set up a trust for your spouse
- When you should set up a trust for your children
- How trusts can provide for dependent parents
- How trusts can provide for other family members
- How trusts can provide for non-family members
- How trusts can save income taxes for your family
- How trusts can save gift and estate taxes

A. Because trusts are excellent solutions to many different kinds of problems. Trusts can be used to:

- Protect against many of the legal and financial problems of disability and old age;
- Protect people from the financial consequences of bad marriages, bad business decisions, or other legal problems;
- Provide asset management for children, grandchildren, or others until they are mature enough to handle their own affairs;
- Avoid estate and inheritance taxes;
- Reduce income taxes;
- Provide professional investment and asset management;
- Prevent family assets like farms or businesses from being unnecessarily divided or sold; and
- Make sure that benefits go to the right people, at the right times, for the right purposes, and in the right amounts.

Properly structured, a trust can be one of the most beneficial methods of holding and transferring property. There are almost unlimited uses for trusts in today's complex society.

Anyone who cares enough to plan for the future must consider the many ways that trusts can benefit the people and institutions that are important to him or her.

Q. How Can a Trust Help Me Personally?

A. By establishing a trust with yourself as beneficiary, you can make arrangements for your future care and comfort. Your trust can include provisions for future contingencies. For example, you may have just retired, have set aside money for yourself, and are receiving a pension. Though it appears you have financial security, you are concerned about managing your money, about disability, and about old age.

While you are well, you could be your own trustee. By establishing a trust with a bank or trust company or with a responsible individual as a "back-up" trustee, you could make arrangements to protect yourself from these potential future problems. If you became disabled or for whatever other reason could not or did not want to handle the assets in the trust, the back-up trustee would take your place. Alternatively, right now you could transfer your assets to a trustee, who would provide professional money management for you and relieve you of the everyday responsibility of handling your money. In the event of your future disability, the trustee would have funds available to use for your benefit, while at the same

time continuing to manage the money. At your death, the trust would provide for the disposition of your funds to those persons or institutions whom you intend to benefit.

Q. Why Might I Want to Establish a Trust for My Spouse?

A. There are many advantages to placing all or some of your assets in trust for your spouse at your death. If your spouse isn't accustomed to managing or handling large sums of money, is not a citizen of the United States, is not the parent of all of your children, or your total assets exceed the unified credit exclusion amount ($1,000,000 in 2002, with increases scheduled for future years), a trust would almost certainly be the best method of providing for your spouse at your death. You should also consider a trust for your spouse in the event of his or her future disability. For example, if you are in a second marriage, have children from a prior marriage, and want to make provisions for your spouse at your death but still provide for your own children at your spouse's subsequent death, a *QTIP trust* is an excellent way to provide for both your spouse and your children. A *spendthrift trust* is also an excellent way to protect your spouse from creditors.

Q. WHY - and When - Should I Set Up Trusts for My Children?

A. Although there are many ways to make provisions for minor children, such as custodial accounts and guardianship, in many instances a trust will do a superior job for your children. A trust can provide professional money management for your children's funds, and distribute income to them in the manner and at the ages you select. This is preferable to a custodial account under which funds are distributed to them when the children reach the age specified under state law (usually either 18 or 21), because children often lack the emotional or intellectual maturity, physical capacity, or technical training to handle large sums of money at those ages. A trust can provide for your children's education and treat them equitably—but not necessarily equally—when appropriate.

For example, if one of your children has serious health problems, you may not want to leave your money equally to all of your children. If your daughter is a successful lawyer, and your son is partially handicapped, you might want to consider providing differently for them.

A discretionary trust may be the best means of providing for a handicapped child's needs and preserving his or her government entitlements. When a spendthrift provision is included in the trust document, trusts can also protect your children from claims of creditors (or their spouses).

Moreover, trusts for children can “sprinkle” the trust funds among them to meet their needs as they arise. In most families, the parents keep all of their money in one pot and use the funds for the children as expenses are incurred. For example, if you go into a shoe store with your young son and daughter, and your daughter needs corrective shoes that cost $25 more than the shoes you are buying for your son, you do not put an extra $25 in an envelope for your son. With a sprinkle trust, you can give your trustee the right to pay expenses as they are incurred without the requirement that all of the children receive exactly the same amounts.

Q. How Can Trusts Provide for Dependent Parents?

A. In practically every instance where sufficient funds are available, a trust will be the best way to provide for dependent parents in the event of your death.

For example, if you have been helping to support your parents by giving them $5,000 a year and you want the payments to continue after your death, you could set up a trust for your parents and fund the trust with $100,000. These funds could be invested by the trustees, with the income (which you assume to be 5 percent, i.e., $5,000 a year) paid (and taxed) to your lower income tax bracket parents rather than to you at your higher tax bracket. At your parents’ death, the balance remaining in the trust would be distributed to your children. This is preferable to giving the money directly to your parents, who may not be in a position to invest it properly, and whose estates could be required to pay additional death taxes on that $100,000, taxes that could have been avoided had a trust been set up. And something could happen to your parents or their estate plans that results in the entire $100,000 going to creditors or other family members instead of back to you or your children.

Q. How Can Trusts Benefit Other Family Members?

A. You should certainly consider trusts if you plan to leave money to grandchildren. Not only can trusts provide your grandchildren’s educational needs, but they can also make provisions to distribute the remaining trust assets to the grandchildren at certain ages.

If you have a deceased child, you can set up a trust for your son-in-law or daughter-in-law during his or her lifetime, with the trust assets reverting to your grandchildren (or other family members) at your in-law’s death.

Trusts can also be used to keep assets such as a home or a business in the family for many years or several generations.

If you have no immediate family, you might want to establish a trust to provide for a favorite niece or nephew, for example, or to provide a permanent source of income for a brother or sister who is not a good money manager.

Q. How Can Trusts Provide for Non-Family Members?

A. There may be certain people who are very important to you and for whom you would like to provide, although they are not related to you. Examples might be members of your church, synagogue, or fraternal order, or a close friend or live-in companion. Trusts can also offer the flexibility, reliability, and strict confidentiality in situations where publicity is not desired. Examples of such situations include making provisions for a child born out of wedlock, a close friend of the opposite sex who is not your spouse, or a lover.

Q. How Can Trusts Save Income Taxes for My Family?

A. It is important to understand our income tax rate structure and how trusts can help reduce the family's overall income tax bite. Income tax rates are progressive. That doesn't mean things get better. It means that the rate of tax increases as your income increases. The more successful you become, the bigger the percentage of your income taken by the IRS. Trusts that can spread income among many family members can shift income to lower tax brackets and save income taxes. For example, suppose you set up a trust for your three children who are each age 14 or older. Assume you are in a 33 percent income tax bracket and each child is in a 15 percent tax bracket. Your family will be paying 18 percent (33–15) less taxes on the income your children receive from the assets in the trust.

Trusts can also be used to defer income until after retirement, when your total income will probably be less, and your income tax rates should therefore be lower.

Since 1986, Congress has taken a number of steps to limit the benefits of income shifting, including the adoption of the so-called "kiddie tax" on the investment income of minors under 14, and the "flattening" of trust tax brackets to limit the amount of trust income that can be sheltered from the top income tax brackets. Because of the complexity of some of these rules, as well as the possibility of new limits in the future, this kind of tax planning will almost always require the assistance of a tax professional.

Q. How Can Trusts save Gift and Estate Taxes?

A. After your gift giving - or your estate - reaches a certain amount, the federal government imposes a considerable amount of taxes if you attempt to dispose of your assets either during

your lifetime or following your death. These taxes—the federal gift tax, the federal estate tax, and for transfers to grandchildren and certain others - the generation-skipping tax—are in addition to any death tax that your state may impose on your estate or its beneficiaries. In no other area can a properly drawn trust save more money for your intended beneficiaries than in the field of gift tax and estate tax planning.

Perhaps the most widely used tax shelter in the entire estate planning area is the credit shelter trust or, as it is often known, the *by-pass trust.* Through the use of the credit shelter trust, a married couple can use both of their unified credit exclusion amounts ($1,000,000 in 2002, with increases scheduled for future years) from estate tax, a potential total of $2,000,000 (or even more in future years), even while the surviving spouse has the income and benefit from the entire estate during his or her lifetime. Used in this way, a credit shelter trust can save $435,000 or more in federal and state death taxes. It makes no sense for a married couple with children, whose total family assets exceed the unified credit exclusion amount, not to consider the use of a *by-pass* trust to save federal estate taxes for their children. Those persons with estates in excess of $1,000,000 should also have an understanding of how trusts can affect the onerous federal generation-skipping tax.

The gift tax law allows every individual to give up to $10,000 (which may be adjusted for inflation) each year to as many beneficiaries as he or she wishes. Gifts that fall within this annual exclusion avoid both gift tax and estate tax. So for estates larger than the unified credit exclusion amount, each $10,000 gift saves at least $3,540 in federal estate death tax. If your estate has the assets and you have the inclination, you may want to take maximum advantage of the $10,000 annual gift tax exclusion. For example, you may wish to use the $10,000 annual gift exclusion to give assets to each of your children. However, you may not want to make an outright gift to a young child, or even an older child inexperienced with handling money. A trust can be the logical vehicle to use to implement your gift. Once the gift qualifies for the annual exclusion, the terms of the trust are limited only by your imagination. You could set up a minor's trust under which the money will be held in trust for your child and made available to him or her at age 21. Or you could set up an irrevocable trust under which your child would receive the income for the rest of his or her lifetime, with allowances made for educational needs, a wedding, or to purchase a business, and the child could be given the right to withdraw certain amounts of principal at stated ages. Gifts with trusts to utilize the $10,000 annual exclusion can also be made to other family members such as nieces or nephews.

If you wish to make even larger gifts, you might want to use a special trust designed to reduce the amount of gift taxes to be paid when making a gift. Through the use of a *grantor-retained annuity trust* (GRAT) or a *grantor-retained unitrust* (GRUT), you can make larger

gifts to obtain the maximum benefit from your $10,000 annual exclusion and your lifetime unified credit exclusion. There is also a trust called a *personal residence trust* (PRT) that can be used to maximize gift tax savings by transferring your home to a trust and reserving the right to live there for a specific period of time.

There is a $1,000,000 exemption (with adjustments for inflation) that each person has that can be used to eliminate the draconian generation-skipping tax. In order to get the greatest benefit from that exemption, it is usually best to apply the exemption to a separate trust, created either during lifetime or at death, for the benefit of your children or grandchildren.

Q. When Should a Trust be Used for Making Gifts to Charity?

A. Trusts can enable you to make larger gifts to charity, while saving income taxes and estate taxes at the same time. Instead of an outright gift or bequest to your favorite charity, you could spell out in a trust document the exact way that you would like your funds to be handled. For example, instead of an outright gift of $50,000 to the United Cerebral Palsy Association, you might want to have that money invested and the proceeds used for needy children with Cerebral Palsy in your hometown. An outright bequest of funds to your college could be individualized to include setting up a trust to establish a scholarship fund for students in your particular area of expertise.

Through the use of a CRT (charitable remainder trust), you could make a gift to charity but reserve a fixed or variable annuity for yourself or a relative for a fixed period of years or even for life. For example, you could make a gift in trust of $75,000 but retain the right to receive $5,000 each year for the rest of your life. Upon making that gift, you would receive a charitable deduction on your income tax return for the value of the gift, less the actuarial value of your retained interest in the trust. There are many other benefits—to you and to the charity—to making gifts in trust which benefit charity, either during your life or at your death.

Q. Are There Trusts Designed to be Used with Specific Assets?

A. Yes. There are trusts specifically designed to purchase and own *life insurance.* Life insurance that you own is includible in your estate for federal estate tax purposes. So you can significantly increase the value of your insurance to your beneficiaries by removing life insurance from your taxable estate through an irrevocable life insurance trust.

There are also revocable insurance trusts, whose primary purpose is to receive the proceeds from your life insurance policies at your death and hold and invest the proceeds for your

beneficiaries on the terms and conditions that you spell out in the trust document. A *pourover* life insurance trust frequently contains the *credit shelter trust* and marital trust.

Trusts can also be valuable tools in the administration or distribution of your *business*. You can use trusts to specify how to operate your business. A trust can also be used as a vehicle for you to make gifts of your corporation's stock with a minimal loss of control. Trusts can help keep the family business in the family after death, and they can establish the machinery to provide for continuity of management and ownership for future generations.

Real estate can often be best handled through a trust. A trust can be used in situations where the real estate in question does not lend itself to fragmentation, but the person establishing the trust desires to spread beneficial ownership among a number of people. For example, land is often more valuable if it is not subdivided; a 10-acre tract of land may be worth substantially more than 10 one-acre tracts. If a trust is used as a receptacle for the gift, 10 beneficiaries could share in the growth and income from the land without necessitating an actual division of the property itself.

If you own several pieces of property of equal value, you could make outright gifts of Parcel A to your son and Parcel B to your daughter. However, you may be treating the children unequally since one property could increase in value, while the other could fall, or the properties could increase or decrease in value at different rates. By placing both properties in trust and giving both children equal shares in the trust property, you could equalize benefits between the children.

Q. Can a Trust Protect Assets from Creditors?

A. In most states you can set up a *spendthrift trust* to protect your family's assets from creditors. These trusts can also help protect your children's assets in the event of marital difficulties, and they can protect a professional person's assets from a malpractice lawsuit. For even greater protection, some lawyers are now advocating the establishment of an *asset protection trust,* which permits the grantor of the trust to safeguard his or her assets by placing them in an overseas trust or in states such as Delaware or Alaska that have laws that provide extremely favorable creditor protection for those who establish trusts in those states.

Q. Can I Place My Home in a Trust?

A. If your home has strong sentimental value to you and your family, you might want to consider placing it in trust and reserving the right to live in it for the rest of your life. At your death, a

trust could give your spouse or dependent child the right to live in the home for his or her lifetime, with provisions for the trustee to pay the cost of maintaining the home.

Your family might also save considerable gift taxes through the use of a personal residence trust, placing the home in trust and reserving your right to live in the home for a certain period of years.

Q. Why are Trusts More Flexible than Other Methods of Transferring Property?

A. Most forms of ownership are very simple, and can deal with only a limited range of possible future circumstances. Also, the rules governing most forms of ownership are fixed by formulas or specific dates or ages, while a trustee can have the flexibility to deal with a variety of changing conditions.

For example, if you want to make a gift to your grandchild, you could simply place money into a bank account or purchase a certificate of deposit or a stock or mutual fund, and title it in the name of your child as custodian for your grandchild under the Uniform Gifts to Minors Act (or Uniform Transfers to Minors Act, whichever is in force in your state). Only one beneficiary is permitted for each account, and the funds must be turned over to your grandchild no later than an age specified by the statute in your state (usually either 18 or 21). Your state also imposes specific regulations on how the money should be titled and invested, and for what purposes the money can be spent.

On the other hand, you could establish a trust for your grandchild or grandchildren, and set up flexible provisions for their future care. All of the money could be placed in one trust, and the trustee could be authorized to use funds for each grandchild's college education, for example. The funds could be held in trust until the youngest grandchild is 25, at which time, regardless of prior distributions, the money would then be divided equally among all of the grandchildren. If a child was disabled or preferred to have the money remain in the trust because of creditor problems, domestic problems, or lack of money-managing experience, the grandchild (or the trustee) would have that option available to him or her at that time.

Since none of us can foresee the future, the flexibility that a trust provides is often its most valuable feature.

Q. How Can Trusts be Used to Solve Unusual Problems?

A. In many instances, a finely tuned trust instrument may be not only the best solution. It may be the only vehicle to deal with an unusual situation. Suppose, for example, you want to make

provisions for an individual who because of age, health, location, or relationship with you makes providing for him or her extremely difficult. These situations could include providing for a handicapped person, relatives who live outside of the country, a child born out of wedlock, a friend of the same or opposite sex, and even the care and maintenance of pets. Trusts can contain the provisions necessary to provide for such beneficiaries, and also give a considerable degree of comfort to the person setting up the trust. There are countless other examples of the many and varied special uses for trusts.

Q. How can a trust assure me of privacy?

A. Trusts offer flexibility, reliability, and confidentiality in situations where publicity is not desired. You can attain your goal with just you and the trustee aware of the nature of your gift and the specific terms of the trust. Most trusts are not accessible by the public during your lifetime, and they are not filed in a probate proceeding at your death. Therefore, it may be possible for you to make whatever arrangements you wish without unwanted publicity.

Here are two examples of situations in which privacy is often desired:

- Gifts in trust in which the grantor does not want the beneficiary to know the identity of the grantor. (Examples include anonymous gifts to a college or other charitable institution or providing for a child born out of wedlock or former or present lover where the grantor desires to remain in the background.)
- Trusts set up for a particular beneficiary of whom the grantor's family is not aware, or with whom the grantor does not wish to be publicly associated. (These could include a trust for another woman or man in your life, a trust for an illegitimate child, or a trust to help a friend or relative pay for a criminal lawyer.)

Q. Why Should I make Gifts in Trust Rather Than Outright?

A. There are many reasons other than estate or income tax savings for making gifts in trust rather than outright. We call these people-oriented goals. If you examine the list below, you'll find that most of the reasons for making gifts in trust fall into one of these three categories:

- You want to guarantee proper management for the assets.
- You want to conserve principal for as long as possible.
- You want income and principal paid out in the time and manner and to the persons of your choice.

See if any of the following situations apply to you or your beneficiaries:

- You are afraid that your beneficiary is unable to handle the asset. If you feel that your spouse, friend, children, grandchildren, niece, nephew, parent, or other beneficiary is unwilling or unable to invest, manage, or handle the responsibility of an outright gift, you should consider making a gift in trust. Minors and legal incompetents are obvious members of this class. So are adults who lack the emotional or intellectual maturity or who do not have the physical capacity or technical training to handle large sums of money or assets that require constant, high-level decision-making capacity such as a family business.

  Legally, a minor cannot buy or sell assets or enter into binding contracts. This means that if property is given to a minor, the property cannot be purchased, sold, exchanged, or mortgaged without the appointment of a guardian by a court and the accounting to the court for every dollar spent on behalf of the minor. Using an irrevocable trust could minimize or avoid that often expensive, troublesome, and inflexible process.

- You fear that your beneficiary will not feel dependent on you. You may want the income and estate tax advantages, but you don't want to put all of the ownership rights in your child or other beneficiary's hands. Suppose you want to start a gift program but you are afraid that if you make no-strings-attached-gifts, your child will no longer feel dependent on you. Unlike an outright gift, an irrevocable trust will *not* allow a beneficiary to "take the money and run" because he or she will not receive it all at one time.
- The property is not fragmentable. Perhaps the property doesn't lend itself to fragmentation, but you still want to spread the benefits among a number of people. (For example, a large life insurance policy and its eventual proceeds may be best held by a single trustee, rather than jointly by a half a dozen individuals.)

  Say you have 10 children and grandchildren. You also have 10 acres of real estate, which may be more valuable to them if it is not subdivided into 10 one-acre plots. If you placed the real estate into an irrevocable trust, all 10 of your children and grandchildren could enjoy the property's growth and income without the need to subdivide it. Upon the occurrence of a specified event (for instance, when the youngest of them reaches age 25 or when the property can be sold for an amount in excess of $100,000 an acre), your trustee could sell the property and divide the proceeds or hold the money for the trust's beneficiaries.
- You want to limit ownership. Consider an irrevocable trust in place of an outright gift if you want to limit the class of beneficiaries. For instance, suppose you want to be sure that stock in your family business, the family vacation home, or Grandpop's pocket watch

don’t end up outside the family. With an irrevocable trust you can make sure that doesn’t happen. You can set up a trust that will retain family control and provide protection against the fallout from a beneficiary’s unsuccessful marriage, for example, and thus prevent his or her spouse from acquiring that asset. Such ownership restriction is not possible if you make an outright gift.

- You don’t want the property to return to you once you have given it away. If a parent makes a direct gift to a child and the child predeceases the parent, absent a valid will, the property may return to the parent rather than pass directly to another child under state intestacy laws. To then remove the asset from the parent’s estate, he or she would have to make another taxable gift. This second gift may be even more expensive than the first because the asset may have appreciated in the hands of the deceased child. Placing the gift in an irrevocable trust, however, can ensure that it doesn’t end up back in your estate.
- You’d like to familiarize your trustee with managing your trust. Initially, your irrevocable trust may have only a life insurance policy and a relatively small amount of investable assets in it. You may plan to “pour over” other assets from your probate estate (assets you own in your own name when you die), from a revocable trust you’ve established during your lifetime, or from a group life insurance plan into the trust. In other words, your trust may be relatively small now but at your death contain a sizable sum of money and other assets. You may want to know now how well your trustee will perform and so you need to familiarize the trustee with your assets, your family, your plans, and the relationship of each to the other. Even though the trust is irrevocable, you can give the trustee suggestions as to property investment and management.
- You desire to protect assets from creditors and predators. You may want to ensure your beneficiary’s financial security, yet not make him or her the target of a fortune hunter. You can do this—create significant economic security but protect the beneficiary from himself and others—by using a trust that provides only income, with additional amounts of principal—at the trustee’s sole discretion—for the beneficiary’s health, education, maintenance, and support. Alternatively, you could give the beneficiary the right to demand certain amounts for specific needs but stipulate that amounts above those levels or beyond those categories of need would be paid out only if the trustee deemed it desirable.

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