

## **MEMORANDUM REGARDING PERSONAL ADULT MANAGEMENT TRUSTS**

### *The Purpose for Establishing Such Trusts and The Benefits to Succeeding Generations*

*[Revised February, 2003]*

This memorandum will act as a guide and instruction to the future beneficiaries and trustees regarding the reasons why a Personal Adult Management Trust (hereafter referred to as PAM Trust) has been chosen to administer your inheritance rather than making an outright bequest of assets to you. First, some background information so that you are better informed as to why such trusts are advantageous to you.

In planning an individual's estate, most estate planners recognize that there are really two tax systems, one for the informed and one for the uninformed. This same rule applies for those who wish to use credit protection strategies as compared to those who do not. There are significant tax, asset and divorce protection benefits that are derived through a well-conceived family estate plan that are not found in using unplanned arrangements. The PAM Trust is one of these planned structures. Your inheritance was placed in a PAM Trust to offer the best opportunity available for you to provide protection of your inherited assets from the claims of creditors and the estate tax collectors.

Under the tax structure we have in the United States, which is called a transfer tax system, properly structured inherited wealth is much more valuable than wealth that is earned and saved. This memorandum will illustrate how this differential applies in your circumstances. The vehicle chosen to achieve and maintain this difference is what is called an "irrevocable trust," which we are calling in this instance, the PAM Trust. This trust may be created by any family member for someone other than the trust beneficiary and his or her spouse, but in this instance it was created by Mr. and Mrs. John Doe. The drafted trust has as much flexibility built into it as legally can be done for tax purposes. It applies to mature competent family members who would otherwise receive property outright except for the benefits that can be derived from the receipt of property in such a trust. The PAM Trust is designed to give the primary beneficiary almost the functional equivalent of outright ownership, including undisturbed control over the investment of the property. As you carefully read the trust provisions, you will see that you as the beneficiary and trustee of this trust have considerable latitude in being able to administer the trust during your lifetime, make investment decisions, and have choices as to the parties who will receive your property either during your lifetime or upon your death.

This trust is not the typical trust that you may be aware of. Unlike some trusts, it is not an inflexible vehicle that restricts your enjoyment of the property. You may have heard horror stories of situations where financial institutions have control of a trust and the beneficiary literally needs to beg for more income to no avail. Contrary to that arrangement, this trust is extremely flexible and allows one to cope with the various problems, both those anticipated and those unanticipated, that have occurred or may occur in the future. One of the prime concerns of a financial institution is the fact that such institutions are governed by state and federal rules regarding investment decisions. These are commonly referred to as the "prudent man rule." Traditional trust language usually precludes the types of investments that you as the beneficiary may wish to make. For example, under the terms of the trust document, the trust may make investments in a closely held family business enterprise no matter in what legal form the enterprise has been set up to function, make loans to your children, or even buy them a house.

## The Benefits of the PAM Trust

The benefits of the PAM Trust as compared to having the assets distributed outright and free from trust can be summarized in the following table:

		<u>Treatment of Bequest</u>	
		<u>Distributed Outright</u>	<u>Held in PAM Trust</u>
1.	Beneficiary has right to all income	yes	yes
2.	Beneficiary has right to invest principal any way beneficiary chooses	yes	yes
3.	Spouse of beneficiary can attach in divorce proceeding	yes	no <sup>1</sup>
4.	Creditors of beneficiary can attach	yes	no <sup>1</sup>
5.	Beneficiary can waste principal, give it away to anyone	yes	no
6.	Asset subject to estate taxes at beneficiary's death	yes	no <sup>2</sup>
<sup>1</sup> This is true only if the spendthrift status provisions are complied with and is subject to certain restrictions and conditions imposed by the state in which the beneficiary and/or trustee reside.			
<sup>2</sup> Only true if held in GST-Exempt PAM Trust			

This trust has been established after reviewing carefully the goals of estate planning and the desires and goals of most families. There are seven primary ingredients that are generally included in most estate plans and are of prime concern to both the party establishing the plan and to the objects of their benefit. These goals are:

1. control;
2. estate tax savings;
3. income tax savings;
4. asset protection;
5. valuation and leveraging;
6. flexibility; and
7. liquidity at death.

1. **Control.** Generally speaking individuals do not want to give up control over assets during their lifetimes. Parents who have built up wealth typically desire to retain it, and upon their deaths, they wish their children, and secondarily their grandchildren, to have the resources and retain control. This function is achieved in the PAM Trust. In the PAM Trust as set forth in the Revocable Living Trust, control is retained by the parents during their lifetimes, and upon their deaths, it is passed on to their designated beneficiaries. Each individual child beneficiary receives his or her interest in a separate trust that he or she alone controls,

if provided for by the grantor. Beneficiaries have a broad special power of appointment that allows them to have control of the disposition of the property during their lifetimes and additional control after their deaths. If so desired you can then pass the benefits down from children to grandchildren. The only limitations are what is called the “Perpetuity Statutes,” which simply limit the life of trusts to the listed persons who were alive at the death of the grantor (or last to die of the husband and wife grantors) of the trust plus 21 years.

2. **Estate Tax Savings.** We are all aware of the advantages of reducing, avoiding, or deferring taxes. Generally most of us are concerned with income taxes, but in order to build up wealth for long periods of time, one must also consider the imposition of estate taxes. Currently the estate tax brackets begin at 37% for estates over the current exemption equivalent of \$1,000,000 (in 2002 and 2003) and reach a high of 50%. In the normal method of transferring wealth from parent to child, child to next generation, and so forth the Internal Revenue Service gets an opportunity to “bite the apple” each time there is a transfer. It can be clearly seen at these tax rates that they take a very big “bite” out each time. Considering that these generations fall somewhere around the 30-year mark, you can see that it is very simple to compare a sum of money that goes through three generations with a tax bite each time compared to the same sum that does not get a bite taken out. The ability to escape estate taxes at each generation is only available to a PAM Trust that is exempt from generation-skipping taxes. Even if the trust does not grow in value through the various generations the net difference is substantial.

**Comparison of estate tax bite of 50% for three generations to no estate tax bite**

	<u>Tax Bite</u>	<u>No Tax Bite</u>
Initial fund	\$100,000	\$100,000
1 <sup>st</sup> generation bite	(50,000)	-0-
Left for 2 <sup>nd</sup> generation	50,000	100,000
2 <sup>nd</sup> generation bite	(25,000)	-0-
Left for 3 <sup>rd</sup> generation	25,000	100,000
3 <sup>rd</sup> generation bite	(12,500)	-0-
Remainder	\$12,500	\$100,000

The above comparison illustrates that, even without any growth in the value of the assets, the big winner after a few generations is the government. If you throw in a modest growth factor, the difference becomes even more pronounced. Without going into the mathematical details, if a modest growth rate is selected (6%), by the time the third bite is taken, the difference will be more than thirty (30) times greater with the no tax bite trust than with the tax bite each time. Thus, the family with no tax bite will have \$30.00 for every \$1.00 the family with a tax bite.

3. **Income Tax Savings.** By proper use of the distribution trustee’s ability to spread income, significant income tax savings can be obtained. For example, assume the following case facts:

FACTS: Couple with three children over the age of 14 have \$175,000 adjusted gross income, \$25,000 in itemized deductions and potential income of \$60,000 from the PAM Trust. Assume the three children are in school and have no other income. Taxes computed for federal and Arizona at 2002 rate.

Alternative I: Distribute the \$60,000 income to the parents.

Alternative II: Distribute \$20,000 of income to each child instead. Under this alternative, because the children have too much income, the parents may not get the exemption allowance, however each child gets the exemption plus standard deduction.

### Results

Alternative I:

Parents' federal and Arizona income taxes	\$60,460
Children's federal and Arizona income taxes	-0-
Total tax bill	<u>\$60,460</u>

Alternative II:

Parents' federal and Arizona income taxes	\$39,569
Children's federal and Arizona income taxes	<u>5,877</u>
Total tax bill	<u>\$45,446</u>

Alternative II tax savings to family:	<u>\$15,014</u>
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4. **Asset Protection Planning.** Asset protection and liability planning has always been a consideration, but given the more litigious nature of our society coupled with the proliferation of divorces, creditor protection is often a very motivating factor. Certainly no one wants to pay any more taxes than necessary, and judgment creditor problems and divorce settlements are also situations for which one does not want to pay excessive amounts. The PAM Trust will offer a significant degree of protection in this area. When an irrevocable trust is established by someone other than the party who is the beneficiary, it provides what most planners consider the ultimate in creditor protection. The asset protection maxim is: "If you don't own it, nobody can take it away from you."

The general rules in trusts are that unless trust property is distributed to a beneficiary, it is protected from the beneficiary's creditors. There have been inroads in this area by legislation and cases, however, the PAM Trust offers the most protection of any legal devices available, if state spendthrift statutes and cases are adhered to. Please note new statutes and cases may make inroads into the ability of such trusts to limit the spendthrift limitation advantage. One only has to look at some famous situations in which wealthy individuals have been sued and are able to fend off creditors' claims against trust assets. In Arizona, former Gov. Fife Symington's ongoing battle with the union pension fund regarding his liability on a mortgage is a typical example. One of his chief "assets" was a trust in which he is the income beneficiary, but the principal could not be reached by his creditors.

We have incorporated into the PAM Trust as much flexibility with regard to the use and enjoyment of the trust funds while offering the highest degree of creditor and divorce protection possible. You must know, however, that certain claims may be made against you as a beneficiary. For example, in some states such assets may not be exempt from child support claims. This area is one that will of necessity be changed in the future as laws and cases are written, but at the present time there is a high degree of protection already in this vehicle against all types of creditors, higher than almost any other device available.

We have made provisions for what is termed the "distribution trustee." The distribution trustee has authority to redirect the income from the named income beneficiary to some other party named in the trust. Furthermore, the distribution trustee also has authority to distribute principal to various beneficiaries. The independence of the distribution trustee and the terms of the trust must be adhered to if tax and legal benefits are to be secured. The trust names JON ROE and the LAW FIRM OF JAMES G. KNOLLMILLER as the co-distribution trustees, who are considered independent of the beneficiary. Only if considered independent can the distribution trustee make such decisions and help provide the income tax

benefits and creditor protection required that someone who is not independent of the beneficiary cannot provide. JON ROE shall act as the contact party for the beneficiaries and will seek the advice of the law firm to make distribution decisions and help provide the income tax benefits and creditor protection required that someone who is not independent of the beneficiary cannot provide.

***Caveat:*** *Arizona Revised Statutes § 14-7706(B) states "a restraint on voluntary or involuntary transfer pursuant to § 14-7701 or 14-7702 is invalid if the sole beneficiary of the trust is also the sole trustee of the trust." Therefore, a spendthrift trust with a sole trustee who is also the sole beneficiary is not an effective restraint against transfer. A recent case, In Re Pugh, 274 B.R. 833 (2002 Arizona) held a trust in which a co-trustee was named as not a valid spendthrift trust. However, the facts of the case were that the co-trustee was the sister of the beneficiary. She did not know she was a trustee nor did she act in any capacity as a trustee. The court concluded that the beneficiary was in reality the sole trustee and, thus, the trust did not qualify as a spendthrift trust. Most states with spendthrift statutes have similar provisions and limitations. Thus it is critical that the trust have a independent third party involved.*

5. **Valuation and Leveraging.** By utilizing the trust to make certain types of investments, the ability to leverage growth of assets in an estate tax-sheltered environment is possible. By utilization of various devices, including valuation discounts and leveraging techniques, there is the ability to multiply the value of this trust several fold for future generations.

6. **Flexibility.** One essential ingredient in all estate plans is to provide maximum flexibility to meet changing family needs and changing laws, particularly the tax law. That is why the PAM Trust has been so structured to be as flexible as reasonably possible to take into account the changing world. There are many provisions within the trust document that provides extreme flexibility in financial and investment planning as well as in the distribution of assets.

7. **Liquidity at Death.** How does one provide for estate taxes? Generally speaking, either one has to accumulate a large amount of cash or liquid assets to be sold at his or her death or to purchase life insurance to provide the cash for estate taxes. Life insurance is traditionally purchased for estate creation and estate preservation. By utilizing the PAM Trust, there is less need for outside liquidity in succeeding generations' estates since their taxable estates do not include the assets of the GST-Exempt PAM Trust. Furthermore, the PAM Trust can accumulate assets and make the dollars available in the form of loans or purchases of assets from the taxable estate of each generation so as to form a bank of liquidity that is not tapped by estate taxes each generation.

### **The "Whys" of Utilizing the Personal Adult Trust**

The PAM Trust has the best opportunity of accomplishing most of the aforesaid seven goals families have when doing their estate planning. It is designed to provide the primary beneficiary with substantially all the rights, benefits, and control over the trust property that he or she would have had the property been owned outright. In addition, there may be tax, creditor, and divorce protection benefits that are not obtainable with outright ownership. These benefits alone are reasons why the PAM Trust is an extremely valuable alternative to outright transfers.

The concept of the PAM Trust is fairly simple. It is a trust where the primary beneficiary is either the sole administrative trustee, or under certain circumstances, has a co-administrative trustee that can make all day-to-day management decisions and investment choices. The fact that the beneficiary is generally also the administrative trustee and is also coupled with a special power of appointment can have the effect of eliminating any potential interference by remote beneficiaries. Remember, the primary beneficiary as

administrative trustee with powers of appointment that gives the administrative trustee the ability to eliminate all participation in the enjoyment of trust assets by future secondary or remote beneficiaries. Therefore, these individuals are not likely to bring a lawsuit or challenge the administrative trustee, since their rights can be eliminated. This ability of the primary beneficiary enables him or her to cut out any complaining secondary beneficiary, and thus, he or she should be free of interference from downline contingent beneficiaries. This is probably one of the most singular and important components of this plan that gives the beneficiary "control."

There are also many situations in which circumstances dictate that an individual should not be given complete control over the assets. Generally speaking, when an individual is legally incapacitated in some way, such as if he or she is a minor, inexperienced, disabled, or lacks certain skills, a co-administrative trustee or a third party acting as a sole administrative trustee may be assigned to manage the trust. Under those circumstances, the trust is not a full, 100% PAM Trust, but it may provide that upon the lapsing of the legal incapacity, the beneficiary can obtain full control. For example, a trust for a 10-year old child could say that other trustees govern the trust until the child reaches age 30, and then the child assumes full management control over the trust.

### **How the Personal Adult Managed Trust is Designed for Maximum Benefits**

The PAM Trust is designed in most situations so that the beneficiary is the primary administrative trustee and has the right to all of the income of said trust. In addition, it has a broad special power of appointment during his or her lifetime and at death to give to a wide classification of individuals except for himself, his creditors, his estate, or the creditors of his estate. The distribution trustee can then (with an open ear to the needs of the beneficiary and his or her family) make reallocations of income for tax savings and direct distribution of principal for almost any reason (within the limits set by the grantor).

The PAM Trust as drafted provides that all of the trust income is paid to the primary beneficiary, unless reallocated by the distribution trustee. If the primary beneficiary is also the administrative trustee, he or she controls the investments and may determine whether he or she wishes to have the trust grow and produce a larger future income, or be invested primarily for a larger current income. If you were to use the services of a financial institution to invest your trust assets, you would learn that they would recommend investments that produce a smaller income for you and greater growth for the remainder beneficiaries, even though you may wish more income. If you desire investment advice, the trust can hire such advisors without limiting your choice of investment opportunities.

### **Investment Choices**

In addition to all of the investment choices allowed under the trustee power section and under state law, we have provided broad additional investment choices that permit you to make investments much as you would do if you had the property outright, including but not limited to the following:

- (a) Invest in family partnerships or business enterprises;
- (b) Acquire a residence or vacation home for yourself or any family member and make loans or aid a family member in acquiring same;
- (c) Acquire tangible personal property such as artwork, jewelry, coins, stamp collections, and other collectibles;

- (d) Invest in all types of investment opportunities;
- (e) Operate with a brokerage firm in having a margin account and buy and sell puts and calls; and
- (f) Make secured or unsecured loans to a wide spectrum of individuals or businesses.

In summary, as the administrative trustee of the PAM Trust, you have almost the same investment decision making capacity as you would if investing your own monies. Furthermore, you are absolved from liability for investment decision mistakes and have the right to tell a contingent beneficiary that if he or she complains how you invest the money, you will simply disinherit him or her.

### **Concern Over Future Trust Beneficiaries**

One of the main concerns that banks and other financial institutions have in administering trusts is the fact that they have to concern themselves with not only the investments that can be made but also the risk that if they do not act in what is called a “prudent manner” they can be sued by the remainder beneficiaries. In the PAM Trust you are absolved from liability if you make investments that are not successful. Furthermore, you are given a “special power of appointment” that allows you, in effect, to disinherit a future potential beneficiary who might threaten you by saying you are mismanaging the trust funds, or for any other reason. You control the purse strings to decide who will receive the money upon your death. However, there are certain limits on your ability to name individuals who will get the money at your death. You are limited to the beneficiaries designated by the grantors of the original trust. Generally, these include descendants and descendants’ spouses of the grantors, spouses of such descendants, parents or grandparents of the grantors, and any public charity; however, the original grantor of the trust can make the potential list very broad or very restrictive.

### **Managing the PAM Trust**

Management of this trust is not significantly different from managing your own assets. You as the administrative trustee are responsible for managing all of the trust assets. It will be necessary to obtain a separate federal tax identification number for the trust and to file income tax returns each year. Under present tax laws, the trust itself would be subject to income taxes. Since the trust normally will distribute all of the income annually, all of the ordinary income will normally be distributed to you as the beneficiary and taxed in your own personal tax return. The trust itself will retain any capital gains and pay income taxes on the capital gains retained. This is of benefit to you because those gains should not be part of your estate but will be in the trust and can be utilized to generate additional income for you if you so desire and pass free of estate tax to your heirs.

***NOTE:** You should be aware that if you are the sole administrative trustee and have discretion to pay income to yourself or another person, you will still be taxed on any income that you pay out to someone else. The IRS will take the position that if you have the authority to give income to yourself, it will be treated as if it were distributed to you first and then as your gift to someone else. That is why you as the administrative trustee are not given that authority. Such authority is given to the distribution trustee and since the distribution trustee is “independent,” said trustee can make such reallocations of income and not have the income taxed to you as the primary income beneficiary.*

A review of the general trustee powers of the Revocable Living Trust will show that there are certain limitations on investments. In addition, state laws generally provide what is called “prudent man” rules for

investments. However, we have provided in the PAM Trust a broad exception to the aforesaid investment limitations. Please review the paragraphs entitled "Special Investment Authority" in the trust documents. These paragraphs allow you to make substantially all types of investments that you as an individual are able to make with your own personal funds but now can be in the form of trust investments. You must be careful to document all investments in the trust name and keep records to show that the trust owns the actual assets. In that respect, the assets should be titled in the name of the trust. For example, if your name was MARY SMITH and the name of your parents' trust was the JOHN & JANE SMITH TRUST, you would then state that the assets are titled: THE MARY SMITH PAM TRUST U/T/A THE JOHN & JANE SMITH TRUST U/A/D \_\_\_\_\_, 20\_\_\_\_\_.

It will also be important for you to keep accounting records detailing the income earned each year, the distribution to yourself of the income as the beneficiary, and the retention of principal. Whenever there is a principal distribution made as a discretionary distribution, records will be kept by you and the distribution trustee stating why the distribution was needed and support the provision that the decision was made by the distribution trustee and not by you as the income beneficiary. These records should be maintained essentially forever, as this trust will be in existence for your entire lifetime and beyond, perhaps even beyond the lifetimes of your children and grandchildren. These records will be important to show tax authorities that the trust in fact was managed as described under the trust agreement and should not be included in your estate or the estates of your children or grandchildren. Some people even maintain a record book similar to that maintained by corporations in their minute books. The better the records are kept, the better the case will be for you and your family if creditors attempt to get at the trust assets, or the estate tax collector tries to prematurely include the trust in your estate. It is important that the trust be treated as a separate legal entity. If there is a co-trustee named or later appointed, said co-trustee must act as such and be aware of his or her responsibilities and duties.

### Summary

The above is a brief summary of the administration and management of the trust as of the time this memo was written. If you have questions, please contact a competent tax advisor who can advise you how the current tax laws apply to these types of entities, since tax laws and other rules will change from the time the trust was drafted until the date the trust becomes effective. For that reason, the LAW FIRM OF JAMES G. KNOLLMILLER has been named as one of the distribution trustees. Said law firm provides legal advice primarily in the trust, estate and taxation fields of law. It currently is headed by JAMES G. KNOLLMILLER, a certified trust and estate specialist and certified tax specialist under the State Bar of Arizona. No one can assure you that any trust is 100% spendthrift proof; however, it has been designed to provide this protection if properly administered and is likely to succeed if challenged in court. Nevertheless, no assurance can be given that in a review of the trust, a court might not uphold the spendthrift provisions. In summary, the trust offers you flexibility in operations, estate tax savings, and creditor protection that no other vehicle can offer. **The LAW FIRM OF JAMES G. KNOLLMILLER works with attorneys in many other states and, if necessary, will consult with local legal counsel in the state of residence of the income beneficiary to determine the then current governing statutes of that state and the status of the law regarding this particular trust in that jurisdiction, to preserve as much of the tax and creditor protection possible for you.**

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### **DISCLAIMER**

**The content of this memo is general in nature and is meant to be used for informational purposes only. Due to possible changes in the law and interpretations of the law, in addition to the uniqueness of each individual situation, this memo should not and cannot be relied upon as an**

**expression of legal advice in your particular situation. Before any action is taken by the reader, it is imperative that legal counsel or professional advisors be consulted. It is also important that legal advice be sought in any jurisdiction in which the trustee or beneficiary may reside in order to obtain the current interpretation of the state law on this type of trust.**

