Estate Planning the Second (or Third) Time Around

By John S. King

Consider the following Example:

Your long-time clients, Robert and Mary, meet with you to review the estate plan you prepared for them in 1985. At that time your clients were in their late 40s with three children in their mid to late 20s. When the estate plan was prepared the clients had probate assets worth slightly less than $800,000 and few if any non-probate assets.

Under the estate plan you prepared in 1985 the clients' estates were to be divided on a formula basis into a marital share and a credit shelter share. The marital share was to be held in a QTIP trust for the sole benefit of the surviving spouse while the Credit Shelter Share was to be held in a trust for the benefit of the surviving spouse and children during the survivor's lifetime. Upon the survivor's death, the assets in the QTIP Trust and the Credit Shelter Trust (together with the survivor's assets) were to be held in separate trusts, one for each of the children. The separate trusts were designed to terminate as each child reached age 40, following partial distributions at ages 30 and 35.

In your meeting, the clients explain that their assets have grown to approximately $2,000,000 and that their children (now in their late 30s to early 40s) are all gainfully employed and, with one exception, happily married. The clients' eldest child, a daughter, is an OB/GYN practicing in Southern California. She is married and has two children. The clients' middle child, a son, is an attorney with a successful criminal defense practice in Upstate New York. He is in the process of getting divorced for the second time and has three children, two from his first marriage and one from his second. The clients' youngest child, also a son, is an elementary school teacher in New Jersey who is about to complete his master's degree in school administration. He is married and his wife is expecting their first child in several months.

Considering the relative success and financial stability of their children, the clients tell you that they think it is time to revise their wills so that, following both of their deaths, their children will receive their inheritances outright. How do you respond?

It is a common occurrence in estate planning that as parents' age and their children mature and become self-sufficient, the parents (and very often their estate planning counsel) conclude that the children no longer need to be the beneficiaries of trusts in order to adequately protect them and their inheritance. What gets forgotten in this analysis, however, are the significant tax and non-tax benefits that can accrue to a beneficiary of a trust.

With proper planning, the beneficiary of a trust created by a third party, such as a parent or grandparent, can enjoy nearly total control over the trust for his or her benefit without subjecting its assets to (i) claims of potential creditors, (ii) failed marriages, or (iii) federal and state transfer taxes.

The purpose of this Article is to suggest to the estate planning lawyer that he or she seriously consider counseling clients to go through the estate planning process a second time around, but that this time they consider working on the estate plans of their children as well as their own.

Creditor Protection

Under EPTL Section 7-3.1, an individual cannot create a "spendthrift" trust for his or her benefit. Thus, an individual with significant risk of liability exposure (such as the clients' daughter) may not protect individually owned assets from creditors' claims. It is well established, however, that the creditors of a beneficiary of a properly drafted spendthrift trust created by a third party cannot force the trustee to make distributions in satisfaction of the beneficiary's debts.

Under New York law there is a statutory presumption that a trust is a spendthrift trust unless the settlor expresses a contrary intention in the trust instrument. Thus, the interest of a beneficiary in a trust may not be assigned or transferred, with limited exceptions.

The principal of a trust for the benefit of a judgment debtor is exempt from application to the satisfaction of a money judgment (provided the debtor is not also the settlor of the trust). CPLR Section 5205(c). In addition, undistributed trust income is subject to creditors' claims only to the extent the beneficiary have an enforceable right to the income. Even in that event, 90 percent of the income remains exempt from application to the satisfaction of a money judgment, except to the extent that a court determines that the exempt property, or a portion thereof, is unnecessary for the reasonable requirements of the debtor and his dependents. CPLR Section 5205(d). In other words, absent a court order, 90 percent of the income distributed to a beneficiary of a spendthrift trust remains free of the claims of the beneficiary's creditors.

A trust for the benefit of a child and his or her issue under which the trustee is given broad discretion to make distributions to or for the benefit of any one or more of the beneficiaries provides a significant level of protection from creditors' claims while still permitting distributions that benefit the "family". For example, a child with a judgment against him would not want distributions made directly to him. However, distributions made directly to the child's children for college tuition (for example) effectively benefit the family as a whole without subjecting the distributed funds to creditor's claims.

Marital Protection

Although inherited assets generally are not treated as "marital property" for purposes of equitable distribution in a divorce setting, many individuals, long before marital problems begin, take the step of placing inherited assets in joint names with a spouse thus destroying the exempt nature of the inherited property. In addition, non-marital property may lose its exempt status if the husband and wife move from New York to another state.

Absent an enforceable pre- or post-nuptial agreement, under EPTL Section 5-1.1- A, a surviving spouse has the absolute right to elect against the terms of a predeceased spouse's will. Accordingly, even if a child does nothing to alter the "exempt" nature of inherited funds, there is a significant possibility that the child's surviving spouse may receive a share of the assets by electing against the child's will.

With certain exceptions pertaining to general powers of appointment, trust assets in which an individual merely has an interest as beneficiary (provided the individual did not place the assets in the trust) are neither subject to a divorcing spouse's claims nor subject to a surviving spouse's right of election. Note, however that a trust can be drafted in a way that permits a beneficiary, through the exercise of a limited power of appointment, to include his or her spouse as a trust beneficiary without granting the spouse an absolute right to benefit from the trust assets.

Transfer Tax Protection.

Congress and the New York Legislature have taken steps recently to minimize the impact of the estate and gift taxes by increasing the amount of assets that can pass free of tax during lifetime or upon an individual's death.

Notwithstanding the recent increase in the so-called "unified credit" and the eventual elimination of New York's estate and gift taxes in favor of a "soak-up" tax designed to collect the federal credit for state death taxes, the impact of transfer taxes remains a significant burden to plan around.

For example, the estate of an unmarried New York resident who dies in the year 2000 with a taxable estate of $1,000,000 will pay federal and New York estate taxes of $125,250. If that same individual survives until the year 2006 (at which time the increase in the federal unified credit will be fully phased-in) and his taxable estate appreciates at the rate of 5 percent per year until that time, his taxable estate will be valued at approximately $1,340,000 and the estate taxes payable will total $141,200.

If that same individual had inherited $500,000 so that his taxable estate in the year 2000 was $1,500,000 and by the year 2006 had appreciated to $2,010,000 the estate taxes would equal $335,250 and $439,900 respectively. The post-inheritance increase in the taxable estate results in an effective rate of tax on the inherited assets of 42 percent in the year 2000 and 44.6 percent in the year 2006.

With proper planning and drafting, assets held in a trust for the benefit of an individual (other than the creator of the trust) will be excluded from that individual's gross estate for purposes of calculating estate taxes. Moreover, a husband and wife have the ability to shelter assets worth up to $2,000,000 from imposition of the generation-skipping transfer tax.

Choice of Trustees

Many people are concerned that if they or their children receive an inheritance in trust, rather than outright, the restrictions imposed on the beneficiary's access to trust assets will present an unnecessary hardship. Of course, such restrictions are often the primary reason a client with young, immature or spendthrift children would utilize a trust in estate planning in the first place. However, as the potential trust beneficiaries age and mature, the need for flexibility in the administration of a trust becomes more important. Usually, once the parents decide that it has become appropriate for their children to receive their inheritances outright, the parents can be convinced that the use of a trust that is in large part under the control of the child/beneficiary is the appropriate estate planning vehicle.

Perhaps the single most important decision in flexible trust planning is the identity of the trustees and the procedures under which a trustee can be removed and replaced. The simplest solution to the trustee question would be the appointment of the child as the trustee of his or her own trust. Unfortunately, provisions of the Internal Revenue Code and Regulations and restrictions under state law make this an unacceptable solution. For example, an individual who is both beneficiary and trustee cannot make distributions of trust income or principal to him or herself without causing the trust assets to be included in his or her estate, unless the ability to distribute is limited by an ascertainable standard relating to the beneficiary's health, education, support or maintenance. Treas. Reg. Section 20.2041-1. However, the use of an ascertainable standard may give the beneficiary an enforceable right to receive trust assets which could limit otherwise available creditor protections. Finally, under EPTL Section 10-10.1, a power conferred upon a trustee to make discretionary distributions of income or principal to him or herself cannot be exercised by the trustee/beneficiary.

Treas. Reg. Section 20.2041-1 provides that under certain circumstances, if a trustee has the power to distribute income or principal to a beneficiary who has the unrestricted right to remove the trustee at any time and appoint another person, including such individual, as successor trustee, then the individual will be treated as having all of the powers of the trustee. As a result, the beneficiary may have to be treated as having a general power of appointment over the trust and its assets would be included in that beneficiary's estate at death.

For many years the Internal Revenue Service fought with taxpayers, unsuccessfully, over the tax effect of an individual's right to remove a trustee and replace that trustee with a new trustee other than the individual holding the removal power. After losing a series of cases the Internal Revenue Service issued Revenue Ruling 95-58 holding that an individual who created an *inter vivos* trust for the benefit of others could, without adverse transfer tax consequences, retain the unqualified right to remove a trustee and appoint an individual or corporate successor trustee that is not "related or subordinate" within the meaning of Internal Revenue Code section 672(c). In Private Letter Rulings the Internal Revenue service has elaborated on Rev. Rul. 95-58 to permit a current income beneficiary of a trust to hold a similar power to remove a trustee and appoint a successor trustee provided the successor is not "related or subordinate". See, e.g., PLR 9746007, 9607008.

Based on Rev. Rul. 95-58 and the letter rulings that have followed, an individual beneficiary may be given the unrestricted right to remove a trustee and appoint a successor trustee who is neither related nor subordinate without risking the inclusion of the trust assets in the beneficiary's estate.

A fairly typical trustee provision in a will or *inter vivos* trust would require at least two trustees at all times. One of the trustees would be a family member trustee (often the child for whom a trust is created). The second trustee would be an independent trustee such as a bank or trust company or individual such as an attorney, accountant or trusted business associate. The will or trust often grants the family member trustee (or the beneficiaries) the authority to remove the independent trustee provided the independent trustee is replaced with a new independent trustee who is neither related nor subordinate to the person possessing the removal power.

Power to Alter Trust Terms

An individual who has inherited property outright has the right to dispose of the property in any way he or she sees fit. However, such inherited property is typically available to satisfy the claims of the beneficiary's creditors and may be subject to marital claims in the event of divorce. During the individual's lifetime any transfer of the inherited property may cause a gift tax. Upon the individual's death the assets will be disposed of in accordance with the terms of his or her will, revocable trust or by intestacy and may lead to the imposition of an estate tax.

Likewise, the beneficiary of a trust (whether *inter vivos* or testamentary) may be given the affirmative authority at death to direct the disposition of the trust assets in whatever way he or she sees fit. During the beneficiary's lifetime, he or she may be able to effectively direct the assets be used for the benefit of other beneficiaries (such as children and more remote issue) by informing the trustee that he has no current need for trust distributions. The difference is that with proper planning, the trust beneficiary is able to do this without destroying the creditor, spousal or transfer tax protections described above and without incurring gift or estate taxes.

In its simplest form, a beneficiary could be given a testamentary limited power of appointment authorizing him or her to direct the distribution of trust assets upon the beneficiary's death to or for the benefit of such "persons, corporations or others" as the beneficiary directs (other than the beneficiary, his or her estate, creditors or the creditors of the estate). Such a limited power permits the beneficiary to completely rewrite the terms of the trust, including the identity of the beneficiaries and their respective interests. For example, the beneficiary could (i) include his or her spouse as a trust beneficiary, (ii) direct that the spouse should benefit only so long as he or she has not remarried, (iii) treat children differently so as to take into consideration differing needs, (iv) name charitable beneficiaries, or (v) direct termination of the trust and outright distributions.

A limited power of appointment can also be more restrictive whereby the person granting the power limits its exercise, for example, to or for the benefit of lineal descendants only.

Conclusion

In view of the protections, flexibility and control that can be afforded to beneficiaries by the use of long-term flexible trusts, such estate planning techniques should be considered by all estate planners.

In the case of the clients described above, their daughter benefits from the use of a trust because her inherited assets would not be available to satisfy the claims of a creditor in a potential medical malpractice action. The daughter may also accumulate a significant estate of her own and by keeping the inherited assets out of her taxable estate there should be a significant tax savings realized by her family.

The clients' divorced son benefits from the use of a trust by keeping the inherited assets free from claims of future spouses while giving him a significant beneficial interest. Also, this son, with children from two marriages, will be able to direct the distribution of the trust assets upon his death as he determines appropriate through the exercise of a limited power of appointment.

Finally, the clients' third child may not appear to have immediate needs for creditor or spousal protection and his estate may not rise to a taxable level. However, with the flexibility in the trust to make distributions among a class of beneficiaries (including the son and his issue), a limited power of appointment and the son's authority to remove the independent trustee at any time, the son will likely be satisfied that he has adequate control over the trust assets to be comfortable with them being placed in trust rather than distributed outright.

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