"ALL ALONG THE DRAFTING WATCHTOWER: HEURISTICS AS TO THE BEST STANDARD PROVISIONS IN YOUR PLANNING DOCUMENTS"

Boilerplate provisions are **not** created equally. Though typically disregarded by your clients as insignificant, these provisions are a key to having excellent documents. Focus is on the most important standard provisions, those that will elevate your documents to the A+ category. Also identified, are out of the ordinary recommendations regarding standard problems, and references to solutions echoed by the Uniform Trust Code.

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"Wisdom is knowing one's limitations"

(Wallace Stegner, Angle of Repose)

I. Objectives of Drafting Estate Planning Documents.

There can be no better test of an estate planner's skill than with creative, focused drafting of estate planning documents to achieve client specific objectives. Tremendous value can be added to any estate plan by inventive, thoughtful estate plan drafting. And yet, whether the **estate planner** feels enriched and intellectually challenged may not be the correct focus. The question is what does the client anticipate and value.

A. Client's Perspective.

Rational or irrational, clients may view estate planning documents as fungible, form like, and pretty much valueless. But they do expect them to be right, and they do expect them to reflect their exact wishes.

1. As to Quality.

Can the client differentiate between a 60 page, single spaced bunch of tax nonsense with internal inconsistencies, and a 30 page well written, concise, internally correct estate planning document?

2. Abort Criticisms.

Clients' comments can be divided into two categories:

a. "You spelled my name wrong."

b. "I don't understand the extent of the trustee's authority under Article 12."

3. What Clients Expect.

Clients assume that all planning documents are drafted correctly, even when there is complex estate tax, trust, or perpetuities drafting. Therefore, a planner is given no room for error merely because the drafting is difficult.[1]

4. What Clients Pay For.

Clients like to minimize costs in parts of the project the benefits of which are not observable. Contrast, for example, the value perceived by clients in flowcharts, projections, analysis and oral meetings, with that perceived in complicated drafting.

[1] Exception: in cases in which this author has been called on to testify, the author has testified that he does not believe that perfection in drafting is the standard of practice in any jurisdiction.

Therefore, the objective of the planner is to provide expert drafting, avoid pitfalls, and achieve the desired drafting objectives, without reinventing the drafting wheel with each project.

B. Reacting to the Client's Perspective.

We could bury our head in the sand and ignore what the client wants. Or we can recognize the client's objectives and structure our drafting life in accord with those dictates. In order of priority, we need to achieve the following objectives:

1. All documents need to be correct in drafting.

2. They should be draftable (not a word) in the most efficient way possible, meaning that there needs to be a "best provision" approach to the template

3. Almost all boilerplate is uninteresting to a client, or at least not an action item, so why spend a client's money on it to redraft? But, you need to have the "best provision" to begin with. And then,

4. Only dispositive provisions need to be considered with the client.

II. Achieving the Objectives.

A. Drafting Practices.

1. Question: do you have a standard estate planning document that you regard as an A template? See Attachment 1 for such a template.

2. The further you regress from, versus to, your Mean[2] estate planning document, the more trouble you get into.

B. Regression from the Drafting Mean.

As a premise, interesting or uninteresting, drafting practices needs to be done in a way that will achieve the greatest result with the least regression from the mean.[3] The reason is that

[2] Mean referring to mathematical “mean,” or average; as opposed to an evil, mean document.

[3] From Wikipedia, "**Regression toward the mean**, in statistics, is a principle that states that if you take a pair of independent measurements from the same distribution, samples far from the mean on the first set will tend to be closer to the mean on the second set, and the farther from the mean on the first measurement, the stronger the effect. Regression to the mean relies on random variance affecting the measurement of any variable; this random variance will cause some samples to be extreme. On the second measurement, these samples will appear to regress because the random variance affecting the samples in the second measurement is independent of the random variance affecting the first. Thus, regression to the mean is a mathematical inevitability: any measurement of any variable that is affected by random variance *must* show regression to the mean.

practitioners have to be focused on risk/return ratios in their practices, and clients would prefer not to compensate planners for the time necessary to create a customized estate planning home.

1. Example One: Client has a current projected residuary estate of $10,000,000. Client wants 10 % to go to his second spouse, provided the amount of his residuary estate is $5,000,000 or less, or 6 % if is residuary estate is between $5,000,000 and $7,500,000, or 5 % if between $7,500,000 and $10,000,000, or 4 % if greater than $10,000,000. Does this make sense? "This is what I want; draft it!"

2. We could draft it, but if you really think about it, this is going to be a 10-20 hour process — does the client really want to pay $5,000 for this provision?

3. The above plan, even if wanted by the client, doesn't make sense and needs to be fine tuned before drafting even begins. E.g., at $5,000,000, the spouse gets $300,000 ($5,000,000 * .06); at $5,000,001, the spouse gets $250,000. How can that be? It can't; the format and game plan needs to be rethought. And the practitioner who starts drafting this monstrosity will soon come to realize it.

4. What happens if a $2,000,000 IRA is changed from the estate as the beneficiary to the spouse, after the documents are done? Clearly this changes the amount to the spouse — was it intended? Does the drafting provide for this, anticipate it?

5. The above dispositive plan is <u>too far from the mean</u> for the practitioner to add value in the drafting to the client. The practitioner must bring the client back to reality as to expectations as to what is to be left to the spouse; *e.g.*, percentage of residue, dollar amount, a percent of the gross estate?

III. <u>There is Boilerplate and Then There is "Best Provision" Boilerplate</u>

A. <u>Best Provisions</u>.

All boilerplate is not created equally. But once you have the Best Provisions boilerplate, you are rocking with the A+ documents, and what we regard as the Mean (or standard/average)

For example, if you give a class of students a test on two successive days, the worst performers on the first day will tend to improve their scores on the second day, and the best performers on the first day will tend to do worse on the second day. The phenomenon occurs because each sample is affected by random variance. Student scores are determined in part by underlying ability and in part by purely stochastic, unpredictable chance. On the first test, some will be lucky, and score higher than their ability, and some will be unlucky and score lower than their ability. The lucky ones are more likely to score above the mean than below it, because their good luck improves their score. Some of the lucky students on the first test will be lucky again on the second test, but more of them will have average or below average luck. Therefore a student who was lucky on the first test is more likely to have a worse score on the second test than a better score. The students who score above the mean on the first test are more likely to be lucky than unlucky, and lucky students are more likely to see their score decline than go up, so students who score above the mean on the first test will tend to see their scores decline on the second test. By parallel reasoning, students who score below the mean on the first test will tend to see their scores increase on the second test. Students will regress toward the mean."

document. Like the kids in Lake Wobegone, the Mean estate planning document is above average…actually it should be excellent.

In this regard, tax provisions, definitional provisions, trustee powers and the like, need to be standardized among your documents, and need to be well thought out and awesome to begin with. Once they are there, how far do you have to diverge with each new estate plan? My premise, very little. See Attachment 1.

B. Quibble with Me.

It is not unreasonable for a practitioner to regard each and every provision of an estate planning document as a provision to discuss with a client. This is not the standard of care in the estate planning industry, but if it is your practice, my premise is still that each document can start with a Best Provision approach, and then vary from this.

C. When do Best Provisions Get Changed.

Estate planning evolves, and this is why we are practicing in this area. Good ideas get implemented, and statutory events require a rethinking of provisions. Premise: this is done on a global basis, rarely on a client by client basis. Examples:

1. Qualified domestic trusts became included in documents as a result of the 1988 Tax Law changes.

2. Credit Shelter/Marital trust drafting was substantially modified in 1982, with the introduction of the first meaningful credit shelter formula. What will happen in 2009? Possibly something requiring a major restructuring of estate plan documents.

3. State law on spendthrift trusts was tightened to provide required language, meaning that this language becomes standard in all documents.

4. In the 1990s, clients start wanting creditor protection and spousal protection features for adult ignore this change, well healed and fully qualified, children, yielding a popular concept in today's documents —lifetime, non GST trusts, for adult children. See discussion *infra*.

5. High net worth clients start thinking that leaving too much money to kids could actually be destructive, leading to thought out incentive or restrictive provisions.

D. Nothing is Obvious.

Good boilerplate requires thought, but once there, it becomes one of those magic moments where one knows that what they have works in 99 % of the situations.

E. Example: Rule Against Perpetuities

Many states have now waived the application of the Rule against Perpetuities, but to opt out of the Rule, states may impose an affirmative opting out in the estate planning document; something akin to the following:

1. Drafting Form.

No Rule Against Perpetuities. I intend that each trust established under this instrument shall be a Qualified Perpetual Trust under State law and shall not be subject to the Rule Against Perpetuities. The power of the trustee to sell, lease, or mortgage assets shall be construed as enabling the trustee to sell, lease, or mortgage trust property for any period beyond the Rule Against Perpetuities. If assets that would not qualify as part of a Qualified Perpetual Trust would otherwise be added to any trust established hereunder, the trustee shall segregate those assets and administer them as a separate trust identical to the one to which the assets would have been added, except that, despite any other provision, 21 years after the death of the last to die of all the beneficiaries living at the time of my death, each such separate trust then held under this instrument that is a GST Separate Trust shall be distributed to the primary beneficiary, if then living, otherwise to the primary beneficiary's then living descendants per stirpes, and each such separate trust then held under this instrument or then held pursuant to the exercise of a power of appointment granted under this instrument that is not a GST Separate Trust shall be distributed to the then income beneficiaries in equal shares.

2. When to Include RAP Waiver Provision.

So the question is whether to include this provision in some, most, all or none of the documents? Clearly it should be in all documents containing GST trusts, and applied to those trusts to waive the rule against perpetuities.

How about trusts that do not contain a violation of the RAP? Don't include, right? . . . Why not? No harm to have a global waiver of the RAP even if the RAP is not violated.

3. Rationality.

And if you are a practitioner that wants to discuss each provision with your client, you would discuss this one, "Do you want the property to vest in a certain generation, like at the grandchild's level?" I submit that there is no rational way for a client to answer this question. If the client is holding funds in trust for the child's lifetime, it is only rational and consistent that these funds should be held for the grandchild's lifetime, and thereafter the great-grandchildren, for as long as there are funds in the trust and the rule against perpetuities is not violated.

The question is not whether the client can answer a drafting question — —do you want to vest all property in G4 —but whether the client has the tools to intelligently answer such a question. I posit they do not. And therefore, in those states that permit, all documents should have an opt-out of the RAP.

F. Divide boilerplate.

Segregate boilerplate into: (i) the Will/living trust category; plus, (ii) the estate tax reduction category (GRATs, grantor trusts, QPRTs, CRTs). Ponder whether provisions can be substituted from one form to the next. Sometimes yes. Sometimes no. With this in mind, we review and craft the Best Provision boilerplate provisions.

IV. Some Unusual Boilerplate and Why They Are the **Best Provisions**.

This outline identifies what this author regards as the most difficult drafting issues facing the planner in today's environment. The outline discusses the drafting issues that could arise, and proposes solutions and language to avoid potential incorrect results, or that better the drafting situation.[4]

A. What is Boilerplate.

By "boilerplate," we mean a provision requiring no decision by the client as to use that provision versus an alternative provision. Once the concept is in the document – e.g., no rule against perpetuities – the drafted provision is included. It is by default typically a provision already drafted which gets built into the document without having to craft new language. No client decision is required as to its language. In this way, it is boilerplate.

B. Beware of the Real Difficult Boilerplate.

We undertake a number of sophisticated planning strategies that have tax and other complex mechanisms built into them that are not discussed with the clients. The clients "expect" the drafter to get these provisions correct; and the planner and drafter become, at some level, the guarantors of the transaction as to the correctness of these variables. The drafting is not always that straightforward. Aside: do planners charge sufficient fees commensurate with the risk for this type of planning? For a discussion of this topic, see the article, "Fees: How To Charge, Collect & Defend Them: Understanding the Legal and Emotional Aspects to Billing and Collecting for Legal Services," presented at the 34th ANNUAL Notre Dame Tax and Estate Planning Institute, Fall, 2008.

V. GRATs to Zero Out or Not to Zero Out and How to Draft.

A. Objective of GRAT Planning

With the stock market dropping faster than the Chicago Cubs in the playoffs, are all of our wealthy clients out there doing what they should be doing — GRATs? Nope, because there is a Catch 22 — clients feeling less wealthy versus gifting when the stock market is low — ahhh,

[4] One word of f: this is a forty-five minute segment; liberties will be taken during the oral presentation that assumes a certain level of expertise with the planning strategies discussed in this outline.

irrational actions which again point to the importance of understanding behavioral economics in understanding clients' actions. [5]

The goal of GRATs is to zero out (or as another school of thought teaches (why?), "near zero out" so that there is a reportable gift) the valuation for gift tax purposes. Zeroing out GRATs for gift tax purposes should have been achievable since 1990. The valuation of the retained interest is a straightforward discounted present value of an annuity for a term of years. The term of years should pay out in the GRAT regardless of whether the Grantor is living or has died during that time. If the Grantor dies during that time, the remaining annuity interest should be paid to his estate. In this way, the value of the annuity will not be based on any life expectancy issues.

But from 1990 through 2000, the IRS did not see it that way. For trusts implemented after January 28, 1992, the regulations introduced and applied (and strongly implied) that a life expectancy factor was required, the so-called "Example 5" to the Regulations. Treas. Reg. 25.2702-3(e), Ex. 5. The question was whether the actuarial assumptions mandated by example 5 in the Regulation to Code Sec. 2702 were valid. If valid, then a GRAT could not be zeroed out and there would always be transfer tax risk if the GRAT did not outperform the 7520 rate.

1. Old (new repealed) Example 5.

The Treasury Regulations initially provided that a GRAT would always have a remainder interest. Preamble to T.D. 8395, 1992-1 C.B. 316, 319. "The governing instrument must fix the term of the annuity or unitrust interest. The term must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods." Reg. § 25.2702-3(d)(3) (emphasis supplied). According to the Service, only the value of an annuity payable for the shorter of the stated term or the period ending upon the annuitant's death may be subtracted from the fair market value of the property contributed to the irrevocable trust in calculating the value of the taxable gift. The Regulations provided an illustration. The illustration provides that when an annuity is retained for a term of years, assuming the annuitant dies within the stated term, and the annuity is then paid to the annuitant's estate, the valuation of the annuity is not based on the stated term. Instead it is valued for the term of years or the annuitant's prior death.

> "EXAMPLE 5. A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death." Treas. Reg. §25.2702-3(e).

The value of that mortality risk would, in every case, represent a taxable gift to the remaindermen.

[5] *See, e.g.*, Thaler, The Winner's Curse (1998).

2. The *Walton* Case.

The litigated question in *Walton v. Commissioner 115 T.C. 589 (2002),* was whether the Regulation illustrating the calculation for a retained term was a valid interpretation of Code Sec. 2702. The initial value of the property transferred in the *Walton* case was just over $200,000,000. If the Regulation were valid, the gift would be several million dollars, but otherwise the gift would be a few thousand dollars.

In a reviewed decision by the full Tax Court, the Regulation was held to be an invalid interpretation of Code Sec. 2702. *Walton v. Commissioner,* 115 T.C. 589 (2000). The Court primarily looked to the statute itself. The Court reasoned that if it had sustained the IRS position then Congressional intent, found in Code Sec. 2702, would have been frustrated because no taxpayer would have been able to create an annuity for a term of years that would be valued as such:

> "[T]here exists no rationale for refusing to take into account for valuation purposes a retained interest of which both the form and the effect are consistent with the statute. We further observe that respondent's attempts to equate the estate's rights here with other contingent, post-death interests are premised on the bifurcation of the estate's interest from that of petitioner. Yet, given the historical unity between an individual and his or her estate, we believe such separation is unwarranted where the trust is drafted in the form of a specified interest retained by the grantor, with the estate designated only as the alternate payee of that precise interest. This is the result that would obtain if the governing instrument were simply silent as to the disposition of the annuity in the event of the grantor's death during the trust term. Additionally, any other construction would effectively eliminate the qualified term-of-years annuity, a result not contemplated by Congress."

3. New Treasury Regulations

Although reluctant to do so, the Service first acquiesced in the *Walton* decision and thereafter the Treasury issued new regulations to this effect. 26 CFR Part 25 [TD 9181]RIN 1545-BB72. Zeroed out GRATs can be structured without the Example 5 overhang. This is a tremendous impetus to the use of GRATs, because now highly volatile investments, capable of substantial returns in excess of the 7520 rate, can be put in the GRAT without concern, from a transfer tax standpoint, of these assets severely dropping in value.

4. And the Future Holds…?

And behind door number 3 is an attempt, again, by the Treasury to cut back on the effectiveness of GRATs by imposing further limitations, perhaps this time a minimal remainder value concept. My recommendation to the Treasury –encourage Congress to enact legislation; otherwise, the Treasury's actions are *ultra vires.*

B. Why Boilerplate.

There is no discussion with the client as to How to Zero Out a GRAT, merely the result. Therefore, the drafting needs to exist already. No client decision. In this way, it is boilerplate.

C. Best Provision Drafting for the Zeroed Out GRAT.

Drafting for the zeroed out GRAT is not a straightforward proposition. Ideally, the drafter would like to provide that if the grantor dies before the end of the retained term, the remaining GRAT is paid to the grantor's living trust or Will. But this could cause a merger of trust interests and according to the Service, render the "zeroing-out" unavailable (there is not much logic, by the way, to the Service's position).

1. Annuity Payments to the Estate

On a zeroed out GRAT, if the annuity payments are made during the expressed term, whether the grantor is dead or alive, the discounted present value of those annuity payments are zero. If the grantor is dead, the remaining GRAT annuity payments should be paid to the grantor's estate. Therefore the "estate" takes over in a sense as the recipient of the annuity.

a. Example 1: Annuity Payments of Death

The grantor sets up a 5 year GRAT, meaning that she gets an annuity during this 5 year period. Each year, she must get 23 % of the initial fair market value of the GRAT in order for her interest to equal 0; that is, receiving 23% per year for 5 years, under an assumed 7520 rate environment of 4.8%, results in the grantor retaining 100 % of the initial value transferred to the GRAT. No taxable gift is made for gift tax purposes. If the grantor dies in year 4, after receiving the first 3 payments, where must the remaining 2 payments be made to? The GRAT must prescribe that those payments be made to the "grantor" who, when she is dead, becomes her estate.

2. Beware of Treasury Regulation Language

The regulations provide:

"§ 25.2702-2 Definitions and valuation rules.

(a) * * *

(5) Holder. The holder is the person to whom the annuity or unitrust interest is payable during the fixed term of that interest. References to holder shall also include the estate of that person."

Does the term, “estate,” mean “living trust?” It should conceptually; but it doesn’t say that.

Accordingly, a more careful drafting approach is to provide that remaining annuity payments go to the grantor’s estate or, if it qualifies as an “estate” under the regulations, then to the grantor’s living trust.

a. *Drafting Example*: Annuity Payment Structure to Estate.

"**Annuity Payments**. On each anniversary of the date of the creation of the trust, the trustee shall pay to me or, if I am not then living, to the personal representative of my estate, the “annuity amount,” as subsequently defined in this paragraph. The “annuity amount” shall equal an amount equal to X% of the initial fair market value of the property transferred to the trust on the date of execution of this agreement, as finally determined for federal tax purposes; provided, however, that if the annuity amount is paid to the personal representative of my estate, it shall also include the excess of the net income of the trust over the said percentage amount of the initial fair market value. Notwithstanding any other provision, no payment shall be made during my life from the Annuity Trust to any person other than me, and no payment shall be made from the Annuity Trust to any person or entity other than the personal representative of my estate if I shall die before the termination of the Annuity Trust."

b. *Drafting Example*: Annuity Payment Structure to Lifetime Trust

"**Annuity Payments.** On each anniversary of the date of the creation of the trust, the trustee shall pay to me or, if I am not then living, to the then acting trustee of the Bill Jones Trust, dated February 16, 2001, as amended and restated from time to time and as in effect at my death (my "Living Trust"), or if my Living Trust shall not be in effect at my death (or shall not be my estate for purposes of the treasury regulations), then to the personal representative of my estate , an amount equal to X% of the initial fair market value of the property transferred to the trust (“the annuity amount”) determined as of the date of the receipt of property. No payment shall be made during my life from the Annuity Trust to any person other than me, and no payment shall be made from the Annuity Trust to any person or entity other than my Living Trust or the personal representative of my estate (or the successor in interest thereto) if I shall die before the termination of the Annuity Trust."

D. Marital Deduction Issues with Zeroed Out GRATs

1. Qualifying for the Marital Deduction

When a GRAT is established and there could be a surviving spouse, then consider whether the plan should include a marital deduction if the first spouse passes away before

the retained term expires. In that case, though the GRAT would be included in the gross estate, it would qualify for the marital deduction and defer taxes (or not use any part of the applicable exclusion amount, currently $2,000,000 or, now that we are in 2009, $3,500,000?[6]). Therefore, drafting should allow the GRAT that comes back into the first spouse's gross estate to qualify for the marital deduction.

2. How to Satisfy Income Requirement in QTIP from GRAT

To accomplish this, it is important to consider a couple of boundaries. First, to make sure that the GRAT qualifies for the "zeroing out" treatment, the GRAT will provide that the remaining annuity payments continue to be paid to the decedent's estate. This should be enough to qualify for the marital deduction, like any other property that would be payable directly to a decedent's estate. However, to be overly protective, a provision can be included to make sure that all income from this property is paid to the spouse during the period of administration.

a. *Drafting Example: Income from GRAT to Marital Trust*

> "**Income Attributable to GRAT**. Anything contained in this instrument to the contrary notwithstanding, the marital trust shall be entitled to receive or be allocated, either directly or indirectly, any property from a so-called "Grantor Retained Annuity Trust" ("GRAT") , and in order to cause the value of such property to qualify for a marital deduction in determining my taxable estate under the marital deduction provisions of the federal estate tax law applicable to my estate. The income from the GRAT property therein to be received, but not yet received during any taxable year, by the marital trust must be paid to my spouse not less often than annually, and the Trustees of the marital trust shall distribute to my spouse at least annually, in addition to any other amounts required to be distributed to my spouse , all of such income or an amount equal to all of such income, to the end that the value of such property will in fact qualify for such marital deduction, and the provisions of this paragraph shall be construed and interpreted broadly to carry out my said intention."

The GRAT should provide that any property that remains in the GRAT after the retained term expires, be distributed to the spouse, outright, or to the decedent's estate planning documents (and presumably, under those documents, from the residuary estate to the spouse outright or in a marital trust, effective as of date of death).

b. *Drafting Example: Final Distribution from GRAT to Marital Share*

> "**Distribution on Termination If I Am Not Then** If I am not living on the Annuity Trust Termination Date, then the trustee, after paying the Final Annuity

[6] Note that this outline was turned in in mid November, 2007. Actions taken subsequent to this date may have impacted the amounts of the applicable credit as set forth in this outline.

Amounts (assuming they have not been paid prior to the Annuity Trust Termination Date), shall distribute the remaining income, if any, and principal, if any, of the Annuity Trust to the then acting trustee under that certain Declaration of Trust known as the "JOHN SMITH 2005 TRUST," created by me as Settlor on January 1, 2005, as previously amended by me and as may be further amended by me at any time and from time to time prior to my death ("my Declaration of Trust"), to be added to and become a part of the "Trust Estate" thereunder, and to be held, administered and distributed as a part thereof, as provided in my Declaration of Trust as in force at my death, or if my Declaration of Trust is not in force at my death, then to the personal representative of my estate."

VI. Marital Deduction Formula Generally

A. Much has Happened the last 25 Years in this Area.

The problems with formula allocations were (a) initially created by the 1982 Tax Reform Act, (b) modified by subsequent changes to the estate tax laws, (c) most recently impacted by the changes to the estate tax laws introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub.L. No. 107-16, 115 Stat. 38, and (d) compounded by the response of many states to the law's repeal of the federal credit for state death taxes.

In every case in which the attorney is considering a formula allocation (principally marital deduction and generation-skipping planning), the following issues must be carefully considered, but this does not mean that a boilerplate provision and approach is inappropriate. Among the newest issues:

How does the estate plan allocate the future increase in the applicable exclusion amount and the generation-skipping exemption amount? These amounts were $2,000,000 in 2008 and $3,500,000 in 2009. Typically, formula clauses allocate these amounts — regardless of size — to credit shelter trusts or GST Trusts. Is this allocation appropriate to the size of the estate and the general plan of distribution?

Does the estate plan consider the possibility that the client may die in 2010 when estate taxes are repealed altogether; or that estate tax repeal may be permanently enacted, or that the credit may return to its lower $1,000,000 shielding effect in 2011?

Does the estate plan consider the effect of the decoupling of state death taxes and the potential death tax cost of fully funding a Family Trust with the federal applicable exclusion when the state allows only a lesser exclusion?

B. Why Boilerplate.

There is no discussion with the client as to which marital deduction formula to use, or even whether to incur a bit of state inheritance tax at the first spouse's passing to maximize the credit shelter trust. Before a few of you jump up from your seats in the audience, this conclusion is intended to be an objectively reasoned result based on what clients value and how they can make decisions. *E.g.*, ask a client today if, 20 years from now, she wants to incur $20,000 in state inheritance tax in order to save, 10 years thereafter, $50,000 in federal estate taxes,

assuming all known variables today are the same (they won't be)) 20 and 30 years from now? You may as well ask them if they believe the genesis of the Vietnam War was a result of the US policy toward Taiwan and Mainland China in the 50s, and the Country's decision to intervene in Korea? Really, how can a person realistically make this decision or know the answer? Or, more importantly, care. They cannot and do not.

Therefore, the drafting needs to exist already.[7] No client decision. In this way, it is boilerplate.

C. Allocation of Future Increases In Exclusion And Exemption Amounts and Applicable Credit Amount

Many estate plans provide for a division of assets between a credit shelter amount and a marital amount, according to a formula that allocates the maximum amount that can be shielded from tax to the credit shelter gift. As the applicable exclusion increases, a greater portion of the estate will be allocated to the credit shelter amount, and in some estates, perhaps all of the property will be so allocated. When the surviving spouse is the mandatory income beneficiary of the credit shelter trust, the greater allocation to the credit shelter amount should not distort the estate plan.

But if the spouse is not a beneficiary, or is only a discretionary beneficiary (as is often the case, especially in second marriages), then there is a real danger that the spouse will be deprived of a meaningful share of the client's estate.

The danger of a distortion is even greater if death occurs in 2010 or if repeal is made permanent (funny, I don't recall Barack indicating that he was in favor of permanent repeal). For example, if the estate tax is repealed and a typical credit shelter or limited marital deduction formula is used in the decedent's document, with no change after repeal, all of the probate or trust estate will go to the credit shelter share. This is true regardless of the formula used to create the credit shelter share.

1. Drafting Example: (Formula Credit Shelter Bequest).

A typical formula may read:

> 3.3 *Gifts if Spouse Survives.* If my spouse survives me, then I make the following gifts:
>
> (a) *Family Trust.* I give the tax-sheltered gift to the trustee to hold as the Family Trust.
>
> (b) *Marital Trust.* I give the balance of the trust estate to the trustee to hold as the Marital Trust.

[7] As we will see, the boilerplate drafting in this regard takes a "wait and see" approach.

The definition of the "tax sheltered gift" typically will mean all property that can pass free of estate taxes other than by reason of the marital deduction, meaning all property.

2. The Danger of Excluding the Spouse as Beneficiary of the CST.

If the credit shelter share does not include the spouse as a beneficiary, then the spouse effectively will be disinherited in this plan. This suggests that the attorney should carefully consider always including the spouse as a potential recipient of the credit shelter share, if not as a mandatory income beneficiary, then as a discretionary beneficiary with preferred status. Those distributions should be pursuant to an ascertainable standard if the spouse is also a trustee.

a. *Drafting Example*: *The problem of Excluding the Spouse as Beneficiary*

A credit shelter trust could read as follows:

> *"Discretionary Payment of Principal.* The trustee may pay as much of the principal to any one or more of my descendants as the trustee from time to time considers necessary for the health, maintenance in reasonable comfort, or education of each of them. "

Because the spouse is not a beneficiary of this trust, the spouse could unintentionally be disinherited. Consider instead a provision that includes the spouse as a beneficiary and provides the spouse with a lifetime limited power of appointment to descendants.

b. *Drafting Example: Spouse as Beneficiary of CST*

The trustee shall administer the Family Trust as follows:

Mandatory Payment of Income. Beginning with my death, the trustee shall pay all the income to my spouse.

Discretionary Payment of Principal. The trustee may pay to my spouse as much of the principal as the trustee from time to time considers necessary for the health or maintenance in reasonable comfort of my spouse. I recommend that the trustee make no payment of principal to my spouse if any part of the principal of the Marital Trust is reasonably available for those purposes.

Lifetime Power of Appointment. During my spouse's life, the trustee shall distribute the Family Trust to any one or more of my descendants and their spouses as my spouse from time to time appoints.[Make sure this power is disclaimable under 2518 under the

document and if FT is converted to a QTIP, this power must be disclaimed.]

D. Factoring in the Spouse as Trustee.

When the spouse is acting as sole trustee of the Family Trust, adverse estate tax consequences are avoided by using an ascertainable standard relating to health, support, maintenance, or education. If the discretion to distribute principal is broadened, the practitioner should carefully review Code §2041. If the standard is broadened to a non-ascertainable standard (one not relating to what is necessary for the spouse's health, support, maintenance, or education) and the spouse is acting as a trustee, the spouse's power to pay principal to himself or herself would be a general power of appointment under Code §2041, thus causing the Family Trust to be included in the spouse's estate and defeating the tax objective of the Family Trust. For example, the power to distribute principal for the spouse's welfare or best interests likely would be a general power of appointment if the spouse were acting as sole trustee and would result in the property being included in the spouse's estate when he or she dies. Accordingly, only if the spouse is not acting as a trustee should the standard for the discretionary payment of principal be broadened. Also, if the spouse's minor children are eligible beneficiaries of the Family Trust, even a narrow standard could cause problems. For example, if the spouse is acting as trustee and may distribute principal to his or her minor children for their support, the power to distribute principal for the purpose of discharging one's legal obligations would be a general power of appointment. See Treas.Reg. §20.2041-1(c)(1).

If the form allows the spouse to appoint the property to any of the grantor's descendants during the spouse's life, and if the power is exercised during life, then there are potential gift tax concerns. The IRS takes the position that the exercise of a limited power of appointment during life is a gift of the income interest in the property by the person exercising the power if the person exercising the power has a mandatory right to the income from the trust. *See* Treas.Reg. §§25.2514-3(b)(2), 25.2514-3(e). The Court of Claims held contrary to the IRS interpretation in *Self v. United States*, 142 F.Supp. 939 (Ct.Cl. 1956). This possible gift tax issue should be understood and discussed with the client before any lifetime power is exercised, especially because the Service has announced that it will not follow *Self*. Rev.Rul. 79-327, 1979-2 Cum.Bull. 342.

E. Drafting for Decoupled State Death Taxes

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, in the majority of states the state death tax was purely a function of the federal estate tax. For example, Illinois abolished its inheritance tax for decedents dying after December 31, 1982. In these so-called "pick-up" tax states, the state death tax was simply whatever credit was allowed pursuant to the federal calculation. If there was no federal estate tax, there would be no state death tax. This course of action not only simplified the administration of estates (many older clients continue to be concerned about bank accounts being "frozen" at death and the need to obtain inheritance tax waivers to transfer assets), but also reduced the incentive of some wealthier clients to change domicile for tax-motivated reasons.

The federal credit for state death taxes was factored into planning through the marital deduction formula. Prior to 2005, the typical "reduce to zero" formula was designed to produce the largest tax-free amount that would result in no federal or state pick-up taxes.

1. The Problem.

Under certain state statutes, the applicable exclusion amount is frozen, such as say at $2,000,000 (Illinois for example). The typical formula clause that creates a credit shelter trust that reduces federal taxes to zero without reference to state taxes will result in a state death tax at the death of the first spouse. For example, assume that in 2009 a married person dies with a typical "reduce to zero" estate plan, bequeathing the applicable exclusion amount to the Family Trust and the balance of the estate to the surviving spouse or to a marital deduction trust for the surviving spouse. A gift of the largest amount necessary to reduce federal estate taxes to zero would produce a Family Trust of $3,500,000 but would incur an Illinois tax of approximately $229,200. The only way to avoid this tax would be to limit the size of the Family Trust to $2,000,000, but doing this forgoes the use of the deceased spouse's full exclusion amount, thus exposing an additional $1,500,000 of potential tax at the surviving spouse's death, if there is such an estate tax. Most traditional marital formula clauses do not address this problem because they direct the fiduciary to consider the federal *credit* for state death taxes, not state death taxes themselves.

If the choice is between paying a tax in 2009 to increase the size of the Family Trust or avoiding a tax but increasing the size of the surviving spouse's estate, then one must compare relative tax rates. This seemingly simple comparison is compounded, however, because (a) under current law there is no tax at all if the surviving spouse dies in 2010, (b) most planners believe that the current system is so unworkable that Congress is sure to make some major change, (c) the surviving spouse's gross estate may not, even with the limited family trust size, incur a federal estate tax.

2. Why the Solution is Boilerplate.

The alternatives — incur State death tax at first spouse's passing or defer until surviving spouse's passing — are something that cannot intelligently be discussed with or determined by the client currently. Flexibility should be built into the document. Either way is sufficient, though I prefer the minimum estate tax route.

3. Reduce to Zero Estate Tax Formula.

First, if the Family Trust is a net income trust for the benefit of the spouse, the client generally may not need to make any further revisions to the plan. If the first spouse's death might produce a tax (such as an Illinois resident's death in 2009), the executor or trustee can manage the state death tax situation by making a partial QTIP election with respect to the Family Trust, choosing to limit it in order to avoid or minimize the state death tax.

For example, if an Illinois spouse dies in 2009, a partial QTIP election with respect to a net income Family Trust could limit the taxable estate to $2,000,000, thus avoiding the Illinois tax.

a. Partial QTIP Election.

Wife dies in 2009 and her estate plan provides that the first 3.5m of her estate passes to a credit shelter trust. The remaining balance, say, 2m, passes outright to the spouse. As to the credit shelter trust, her husband is a mandatory income beneficiary and the sole discretionary principal beneficiary. The State of Illinois imposes an estate tax on all non marital dispositions in excess of 2m. The husband does not want to incur Illinois estate tax at that time. Therefore, as to the 3.5m CST, the executor elects to have 1.5m of that (1.5m/3.5m) treated as QTIP, thereby qualifying it for the marital deduction. The remaining 2m is a CST. The CST divides into two trusts pursuant to the terms of the document. There is no State estate tax, though the new 1.5m QTIP trust will be included in the husband's gross estate.

b. *Drafting Example: Qualifying CST for QTIP*

Make sure that the CST will qualify for QTIP treatment. Two requirements to keep in mind here: mandatory income + no discretionary beneficiary of the trust during the spouse's lifetime other than the spouse. This is the approach taken in the annotated form, attached. The following would so qualify:

Article 5
Family Trust

The trustee shall administer the Family Trust as follows:

Mandatory Payment of Income. Beginning with my death, the trustee shall pay all the income to my spouse.

Discretionary Payment of Principal. The trustee may pay to my spouse as much of the principal as the trustee from time to time considers necessary for the health or maintenance in reasonable comfort of my spouse. I recommend that the trustee make no payment of principal to my spouse if any part of the principal of the Marital Trust is reasonably available for those purposes.

4. Iteration to Solution.

The net income Family Trust, however, may not be desirable for a number of reasons. First, the client may not wish to have all of the income payable to the surviving spouse.

In larger estates, the ability of the trustee to accumulate income, or to pay it among descendants pursuant to discretionary authority, helps to minimize the surviving spouse's estate and can result in a lower over-all income tax rate, to the extent children or grandchildren are in lower tax brackets than the surviving spouse.

A second disadvantage of the net income Family Trust is that a partial QTIP election may require future principal invasions for the benefit of the surviving spouse to be made on a pro-rata basis from assets some of which will be, and some of which will not be, taxable in the surviving spouse's estate. One could draft around this potential problem by allowing division of QTIP/non-QTIP Credit Shelter Trust into two separate trusts.

5. Have Credit Shelter Formula Reduce Taxes to Zero and Use Wait and See Approach for QTIP Marital v. Family Trust.

An alternative is to use a formula that minimizes the total tax burden, while creating a residuary QTIP trust. Then, if the benefit of having a larger credit shelter trust is deemed to outweigh the detriment of incurring State death tax at the first spouse's passing, on the first spouse's estate tax return, a partial QTIP election can be made, the non elected portion carved out in a separate trust, and that separate trust will both pay the state estate tax, and also be free of estate tax at the surviving spouse's passing.

VII. Generation Skipping, Lifetime Trusts and Hanging Powers

A. GST Lifetime Trusts are not Your Typical Bear Yogi-Beware 2514(e).

Crummey trusts typically create gift tax issues for the beneficiaries (**not** the grantor who uses his or her annual exclusion). The right of withdrawal is a general power of appointment under Regs. 20.2041-1(c)(i) and 25.2514-1(c)(i). The beneficiary's withdrawal right usually expires at the end of a certain period of time. At the expiration of that time, the withdrawal right (i.e., the general power of appointment) is said to **lapse** as to that portion over which the beneficiary could have, but did not, exercise the withdrawal right. A lapse of a power of appointment is a **release** of the power to the extent that the property that could have been appointed exceeds the greater of: (1) $5,000, or (2) 5% of the aggregate value of the assets out of which the exercise of the lapsed powers could be satisfied. Section 2514(e).

To the extent it is not treated as a release, a lapse is not a transfer for gift tax purposes. Under Section 2514(b), the release of a power of appointment is a transfer for gift tax purposes by the beneficiary releasing the power. The transfer is to the trust, and the beneficiary has made a taxable gift to the trust if the trust terms do not provide the beneficiary with sufficient control and dominion over the trust so as to render the transfer incomplete for gift tax purposes. Reg. 25.2511-2(b) and (c). Absent unusual trust terms, no gift tax annual exclusion is available to the beneficiary because the transfer is a gift of a future interest.

B. Using Hanging Powers to Cleanse 2514(e) Lapses

1. Why Generic.

Clients are focused on giving away $12,000 (now $13,000) per year per donee free of gift tax. When planners discuss the need for withdrawal rights in trusts to qualify for the annual exclusion, clients' eyes glaze over, their heads bob up and down, and eventually they fall asleep in a confused state. Eventually, we are able to explain why withdrawal rights are needed under Code section 2514 (b). To expand this discussion

and explain the gift and estate tax consequences to the beneficiary of not exercising the withdrawal right – a right which we have told the client 10 minutes previous is one that should not be exercised – may be the equivalent of trying to teach them the underpinnings of calculus (i.e., "real analysis" in math terms). Though we practitioners have tried valiantly in the past to undertake this discourse, the reality is that planners do not expect the children or grandchildren to have gift and estate tax consequences as to the withdrawal right in a GST trust. Accordingly, the solution to the section 2514 (e) must already be built into the document. And in that way, it is generic. (By the way, the language cited below, though it is state of the art in the way it addresses the issue, is unbelievably difficult to conceptualize.)

2. Preventing Lapses.

The question is how to prevent the lapse of a withdrawal right from being a taxable gift by the beneficiary. One solution is to allow the withdrawal power to lapse only as to the amount that Section 2514(e) protects from treatment as a release (*i.e.*, the greater of $5,000 or 5% of the value of the property out of which the withdrawal right could have been satisfied). The withdrawal right over the remaining amount is carried over to future years and lapses only when such lapse will not be a taxable gift.

a. *Example: Lapsing Powers Cause Problems*

If A's and B's withdrawal rights expire at the end of 30 days without being exercised, then each of them has released a general power of appointment and therefore has made a transfer for gift tax purposes equal to $12,000 (the amount they could have each withdrawn) minus the greater of (1) $5,000 or (2) $1,200 (5% of the total amount from which each withdrawal right could have been satisfied). A and B have each arguably made taxable gifts equal to $5,000.

b. *Example: Hanging Open the Withdrawal Rights*

Donor contributes $22,000 in year 1 to a trust for the benefit of A and B. A and B are given withdrawal rights so that Donor can avail herself of the $12,000 per beneficiary annual exclusion from gift tax. A and B are discretionary income and principal beneficiaries; the balance of the trust is to pass to A and B, in equal shares, at Donor's death, if they are both living, or all to the survivor if one is alive.

Assume the document uses a hanging power. In this case, A's and B's withdrawal rights will lapse after 30 days as to only $5,000; the withdrawal right over the remaining $5,000 will continue in effect until it can lapse without gift tax consequences. In year 2, assume Donor makes no contributions. A and B each have withdrawal rights remaining as to $5,000. In year 2, each withdrawal right, up to $5,000, can lapse without any gift tax consequences.

C. The Service's Position.

TAM 8901004 illustrates the Service's position towards the hanging power. There, the grantor had created an irrevocable trust which allowed for discretionary payments of income to the grantor's descendants during his lifetime. At the grantor's death, the trust property was divided into two separate trusts – one for the benefit of the grantor's son's family and one for the benefit of the grantor's daughter's family. Descendants (and their spouses) were given a 30-day, pro rata withdrawal right over property added to the trust.

If a beneficiary failed to exercise his or her withdrawal right the document provided: "Notwithstanding the above, if upon the termination of any power of withdrawal, the person holding the power will e deemed to have made a taxable gift for federal gift tax purposes, then such power of withdrawal will not lapse, but will continue to exist with respect to the amount that would have been a taxable gift and will terminate as soon as such termination will not result in a taxable gift."

Relying on *Procter*, 142 F.2d 824, 44-1 USTC ¶10,110, 32 AFTR 750 (CA-4, 1944), *cert. den.* the Service held the above-quoted provision was invalid. It stated: "Accordingly, the provision is a condition subsequent and is deemed not valid as tending to discourage enforcement of federal gift tax provisions by either defeating the gift or rendering examination of the return ineffective."

In *Procter*, the trust clause held invalid provided as follows: "However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property . . . shall automatically be deemed not to be included in the conveyance in trust hereunder."

The happening of the condition – a judicial finding that the previous transfer was a taxable gift – rendered the previous transfer voidable (*i.e.*, it undid the prior gift). In a real sense, the *Procter* condition rendered ineffective any attempt by the Service to challenge the taxable gift nature of the transaction. And the *Procter* court held that this was contrary to public policy for three reasons:

1. It discouraged the collection of tax since the only effect of a valid attempt to enforce the tax would be to defeat the gift.

2. It obstructed the administration of the judicial system by making courts pass on moot points.

3. It impermissibly resulted in Federal courts rendering declaratory judgments on whether transfers are gifts for gift tax purposes.

D. Hanging Powers that are not the *Procter* Badboys.

In contrast, the use of a properly drafted hanging power should not be caught by the *Procter* analysis. The *Procter* elements include (1) a transfer which (2) becomes voidable (3) if future action by a court (and, extending the court's reasoning, by the

Service) determines that the transfer was a taxable gift. Assuming that the lapse of the withdrawal right is the transfer (Element 1), this lapse becomes voidable (*i.e.*, it "hangs" and does not lapse) (Element 2), depending on (a) the year of the lapse (*e.g.*., have other lapses by that beneficiary occurred in that year?) and (b) the amount in the trust out of which the withdrawal power could be satisfied. This amount is the permissible Section 2514(e) amount which can lapse each year without being a release.

Whether the lapse becomes voidable, or hanging is not contingent on action by the Service or courts, so Element 3 of the *Procter* reasoning is not present. This fact alone legitimately distinguishes a properly drafted hanging power from the condition subsequent found to be void in *Procter*. (The foregoing analysis renders the theoretical hairsplitting as to whether a hanging power is a condition subsequent or condition precedent unnecessary. Even if a hanging power is a condition subsequent, it is not the type of condition which should be contrary to public policy under the *Procter*, analysis).

The Service found that the hanging power in TAM 8901004 "discourage[d] enforcement of federal gift tax provisions by either defeating the gift or rendering examination of the return ineffective." With a properly drafted hanging power, however, enforcement of Federal gift tax provisions will not affect the existence of the gift (i.e., whether the withdrawal right lapses). Rather, the lapse of the withdrawal right will be tied to Section 2514(e) as it relates to the current status of the trust. A condition that is tied to a statutory provision is not contrary to public policy and should not be rendered invalid under a *Procter*-type analysis.

E. Theories on Drafting the Hanging Power.

Can a properly drafted hanging power be distinguished from the hanging powering TAM 8901004? There, the trust language provided that the withdrawal power given to a beneficiary would not lapse "if upon the termination of any power of withdrawal, the person holding the power will be deemed to have made a taxable gift for federal gift tax purposes (emphasis added).

Arguably, the Service's position, which is not totally clear in TAM 8901004, is that the language could be interpreted as followed: "[I]f upon the termination of any power of withdrawal, the person holding the power will be deemed by the Internal Revenue Service or a court to have made a taxable gift for federal gift tax purposes . . ." (emphasized words not in original text).

Under that interpretation, the condition subsequent is action by the IRS in enforcing a gift, which, is successful, would render the gift ineffective (i.e., the withdrawal right will be deemed to have continued in existence), thereby creating the circularity problem properly objected to in *Procter*.

Alternatively, if the hanging power provision expressly ties the lapse of the withdrawal right to the greater of $5,000 or 5% per year, which is the Section 2514(e) protected amount, the condition is not a *Procter*-type condition. It does not, in the words

of the TAM, "discourage enforcement of federal gift tax provisions by either defeating the gift or rendering examination of the return ineffective."

F. Nuts and Bolts of the Best Provisions for Hanging Powers.

1. Get the Withdrawal Provision Correct.

The hanging power is difficult, difficult, difficult to draft (more so to administer; and query, how many hanging powers are properly administered?). But for a GST trust in which the annual exclusion is being used to allows gifts to be made to the trust, the hanging power must be used. There are two elements to the hanging power; first, a properly drafted *Crummey* withdrawal power.

a. *Drafting Example*: *Special Withdrawal Rights.*

"I intend that contributions to the trust (the "Lifetime Trust") prior to the death of the last to die of my spouse and me shall qualify for the annual exclusion as gifts of present interests for federal gift tax purposes to the maximum extent possible for my children. Following each contribution to the Lifetime Trust, each child of mine living on the date of the contribution shall have a special withdrawal right over an amount equal to the lesser of

i. the value of the contribution divided by the number of my children then living; and

ii. the excess, if any, of the largest amount that then qualifies for the annual per donee exclusion allowed for federal gift tax purposes under Code §2503, assuming that a split gift election will be made if the donor was married on the date of the contribution, over the aggregate special withdrawal rights previously granted to the child under this paragraph during the calendar year.

In addition, to the extent the powers are not exercised, which they seldom will be, in order to avoid a taxable gift by the child, the power must hang, i.e., continue in existence until the lapse can occur without gift tax consequences to the child.

b. *Drafting Example: (Hanging Rights — Conceptually Difficult to Draft but Operationally Effective)*

"13.5 *Termination of Rights.* (a) *Amount and Timing of Termination.* On December 31 of each year, outstanding special withdrawal rights granted under this instrument to a child of mine on or before November 1 of such calendar year or in any prior year shall terminate, if at all, in an amount equal to the greater of

(1) the excess, if any, of $5,000 over the sum of the value of all rights to withdraw that were held by the child

over any withdrawal trust (other than a trust created under this instrument) and that previously terminated during the year or that terminate on that date; and

(2) the lesser of

(a) the excess, if any, of five percent of the sum of the maximum values for all withdrawal trusts for the child for the year over the sum of the value of all rights to withdraw that were held by the child over any withdrawal trust (other than a trust created under this instrument) and that previously terminated during the year or that terminate on that date; and

(b) five percent of the value of the trust assets held under this instrument on December 31 of that year."

VIII. Grantor Trusts

A. Introduction as to Their Uses

1. Nature of the Grantor Trust

The term "grantor trust" describes a trust that has one or more characteristics described in Code sections 673 through 678. A grantor trust is not a separate taxable entity. Code §671. All items of income, deduction, and credit against tax are reported on the individual return of the grantor or, in limited situations, on the return of the individual possessing a grantor-type power over the trust described in Code §678.

The grantor trust was initially established as a weapon of the courts (via common law dominion and control arguments) and the Internal Revenue Service against perceived income tax abuses. The rules essentially apply and treat the grantor as the owner of a trust for income tax purposes if the grantor has sufficient dominion and control over the trust so that the grantor should, from a policy perspective, be treated as the owner. With the compression and decrease of income tax rates, especially at the trust level, the need of the grantor trust concept as a weapon to fight income tax abuse has been greatly eroded. However, the statutory dictates remain in the Internal Revenue Code, as perhaps they must to address the income tax abuse area if (when?) Congress changes the income tax laws.

Interestingly, the grantor trust concept allows for the creative use of estate tax strategies that incorporate the concept into the planning. As a premise, the grantor trust presents one consistent planning opportunity: it can shift the income tax burden away from the trust to the grantor of the trust.

NOTE: There is a distinction between a grantor trust as to income and one as to principal. If a trust is a grantor trust as to income only, then only ordinary income (for example, interest and dividends) is taxable to the

grantor. If the trust is a grantor trust as to principal, capital gains are taxable to the grantor as well. Unless otherwise distinguished, references in this discussion to "grantor trusts" refer to full grantor trusts, ones that tax both ordinary income and capital gains (or must tax those items in this fashion, such as with S corporation stock) to the grantor.

The term "grantor trust" is somewhat of a misnomer. The issue is not who is the creator, or "grantor," of a trust, but rather who contributes property to the trust or who has a withdrawal right over trust property. In the tax sense, the "grantor" is the contributor of funds (without adequate consideration) to the trust. Treas.Reg. §1.671-2(e) ("grantor" includes any person to the extent that person makes a gratuitous transfer of property to a trust).

2. Uses of the Grantor Trust

The use of grantor trusts in estate planning ranges from the straightforward to the necessary to the complicated. The following discussion divides the topics into these categories.

a. *The Straightforward*

i. Living Trusts.

Grantor trust planning is used by the majority of estate planners, but perhaps without any forethought, in one common type of planning, the living trust. The living trust is a revocable trust established by the grantor and available for the grantor's benefit during the grantor's lifetime. It is a strategy intended to avoid probate, provide a mechanism to manage assets in the event of disability, prevent ancillary administration, and ensure privacy.

The living trust is a grantor trust under many sections of the Code, including sections 676, 674, 677, and 673. (Qualification under one section is sufficient.)

As a grantor trust, all taxable income is taxed to the grantor. There is no estate tax advantage because the trust is included in the grantor's estate under Code sections 2036 and 2038. In actuality, the living trust really has no tax advantages achieved by its creation, at least during the lifetime of the grantor. Importantly, there is no reason for the trust not to be a grantor trust. Planners accordingly pay minimal attention to the grantor trust results of these trusts. The living trust involves an important administrative simplification. Because the living trust is a grantor trust, typically with the grantor as the trustee, a separate taxpayer identification number need not be applied for; the grantor's social security number suffices.

ii. Reversionary interests.

If the grantor retains the right to receive the property after a certain period of time, the grantor trust rules may apply. For example, the old *Clifford* trust rules, in which the grantor would transfer property to a trust for a period slightly in excess of ten years, during which time the ordinary income property would be taxed at the trust's rates and after which time the property would pass back to the grantor, have been in effect repealed. Section 673 now requires that the value of the reversion, that is, the grantor's right to receive the property back, must be less than five percent of the initial fair market value of the property contributed. This is dependent on the length of the trust and the applicable discount rates to be used in valuing the grantor's retained interest (see Code §7520) and could, for example, require a trust whose term is 32 years or more if grantor trust rules are to be advised.

iii. Insurance trusts.

Irrevocable insurance trusts in which trust income may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse may be grantor trusts. Although this is the literal rule (Code §677(a)(3)), there is a question as to whether the Service would limit the application to situations in which either income is actually used for this purpose or available for this purpose. See IRS NSAR 20062701F, 2006 WL 2386482 (IRS NSAR)(May 1, 2006) Therefore, though life insurance trusts should be carefully drafted to address this area (but not necessarily to avoid it).

iv. Grantor trusts and annual exclusion gifting (*Crummey* powers).

Another common use of grantor trusts is in annual exclusion gifting involving the *Crummey* power. This is a trust that allows the beneficiary to withdraw all or part of each contribution to the trust, when such contributions are made, to qualify for the $12,000 ($13,000) per donee annual exclusion from gift tax.

In those cases, the withdrawal power invokes Code section 678, a grantor trust provision. That section provides, in essence, that if a person can distribute property to himself or herself, the trust is a grantor trust as to that portion. In a *Crummey* trust, the powerholder has the right to receive property from the trust, usually limited by the annual exclusion. The right to withdraw trust funds should be a grantor trust as to a portion of the trust. Once the withdrawal right becomes exercisable, items of income, deduction, and credit attributable to the amount of principal subject to withdrawal are taxable directly to the beneficiary. Also, as to a lapse of the withdrawal right, the Service takes the reported position that

those tax items attributable to the amount not withdrawn continue to be taxed directly to the beneficiary. See, *e.g.*, Pvt.Ltr.Rul. 8805033 (Nov. 6, 1987). In effect, the beneficiary becomes the grantor of the unwithdrawn portion.

If a trust provides that only part of the trust contribution (not the entire contribution) may be withdrawn, a portion of the trust's tax items may be allocable to the creator or to the trust and another portion to the withdrawal right holder. This would occur, for example, when the withdrawal right is limited to the "5 or 5" amount under Code §2514 and the contribution to the trust exceeds the "5 or 5" amount.

If there is a *Crummey* power and another grantor trust provision under sections 671 – 677 applying to the original grantor of the trust, the provisions of sections 671 – 677 control. Code §678(b).

The above discussion may seem complicated and may make one wonder why this discussion is included as a straightforward use of the grantor trust. The answer is that the issue of grantor trust status in *Crummey* trusts can best be characterized by the phrase "benevolent disregard," both by practitioners and by the Service (for the record, not by all practitioners). Tax preparers perhaps do not want to burden their clients with the costs of complicated accountings and adjustments to do the allocation of *Crummey* trusts as between trusts taxed under traditional Subchapter J and grantor trusts. The Service is not all that concerned in that burdening the trust with the tax usually results in more tax collected.

v. Section 2503(c) minor's trust.

In §2503(c) minor's trusts, the beneficiary has a right to withdraw the entire trust principal upon reaching age 21. The beneficiary will be treated as the owner of the trust commencing when the withdrawal right becomes exercisable, *i.e.*, when the beneficiary reaches age 21. Code §678(a)(1). If the beneficiary allows the withdrawal right to lapse so that the trust principal will continue to be held in trust for that beneficiary, the beneficiary should also be treated as the owner of the entire trust for income tax purposes under Code section 678(a)(2).

b. *The Necessary — The S Corporation Context*

Grantor trusts are often used in the S corporation context to qualify trusts as shareholders. Only certain types of trusts are permissible S corporation shareholders. One permissible type is a grantor trust. (Two types not discussed here are qualified Subchapter S trusts and electing small business trusts. See Code §§1361(d), 1361(e).)

When a gifting trust or other type of trust will hold S corporation stock, qualifying as a grantor trust allows it to be a permissible shareholder. Living trusts

are grantor trusts and therefore automatically qualify as S corporation shareholders.

Other trusts need to have grantor trust specific provisions, such as the power to borrow without adequate security or the power to substitute assets of equivalent value.

When structuring a trust as a grantor trust to be a permitted shareholder of an S corporation, the entire trust, not merely a portion, must be deemed to be owned by one individual who is a citizen or resident of the United States. A withdrawal power limited to the "5 or 5" amount described in Code §2514(e) will not cause the entire trust to be treated as owned by the beneficiary if the value of the stock contributed to the trust exceeds the "5 or 5" amount. Likewise, a grantor-type power granted with respect to only a portion of the trust will not be sufficient to cause the entire trust to be treated as a grantor trust. Therefore, S corporation status would then be jeopardized.

In the S corporation context, the deemed grantor of the trust will be taxable on the trust's pro rata share of S corporation income. This is true whether that income is distributed by the corporation to the trust or from the trust to the beneficiary. Therefore, the potential for unrealized income to the deemed grantor must be recognized. When the beneficiary is the deemed grantor, this problem may be mitigated by including in the trust express language that directs the trustee to distribute to the beneficiary an amount necessary to cover the beneficiary's increased income tax liability resulting from the trust's pro rata share of S corporation income. In the grantor retained annuity trust (GRAT) or sale to grantor trust strategy, there is an excellent interplay between this result and income tax basis planning. If the cash flow needed to sustain the GRAT or sale strategy is less than the S corporation earnings, the corporation should not distribute out all earnings. Undistributed earnings will increase the basis in the hands of the beneficiaries of the GRAT or grantor trust (a good result), even though the income tax on the earnings is paid by the grantor (a good result).

c. *The Complicated — Grantor Trusts as Planning Strategies for Estate Tax Reduction.*

The most interesting use of grantor trusts in today's environment is as a positive means of estate tax reduction. In many situations it is advantageous to draft a trust so that the trust has one or more of the characteristics that create a grantor trust. A trust designed in this fashion is often referred to as a "defective grantor trust." The proper nomenclature, however, should be an "effective grantor trust."

The threshold issue is whether the client is savvy, or perhaps the word should be "comfortable," enough to use the techniques available through grantor trusts. The use of grantor trusts in estate tax reduction strategies is premised on the comfort level of the client.

Specifically, the grantor must be okay with the concept that he or she will pay income tax on assets that may or may not be available for use by the grantor. Planners should pay attention to this concern — even if it is flawed on a cash flow basis — because it is perceived as important to most grantors.

For example, a grantor who has a $30 million taxable estate still may not feel that he or she is able to bear the "burden" of income taxes on income not received by the grantor. This conclusion, if not logically grounded on fact, is nevertheless real to the client, and planners need to plan for this reaction. A discussion of cash flow, perhaps accompanied by spreadsheet analysis as to cash flow (to demonstrate the real impact of the burden of paying the income taxes without the accompanying cash flow), may be enough to convince otherwise reluctant clients that the grantor trust is a viable estate tax reduction strategy.

i. Unified credit, applicable credit amount, gifting trust.

In a straight gifting situation in which the grantor gifts property equal to or in excess of the gift tax exemption equivalent ($1,000,000 in 2009), a gift to a grantor trust is preferable to a gift outright. If the gift is of appreciated assets, the donees will realize the capital gain in the future when the assets are sold. However, if the gift is to a grantor trust in which the grantor retains no interest other than that necessary to make it a grantor trust, then future capital gains will be paid by the grantor instead of the trust. In addition, ordinary income and other taxable income incurred annually can be allocable to the grantor of the trust. This has the effect of increasing the estate-tax-free property in the hands of the donees while decreasing the estate-includible property in the hands of the donor.

ii. Grantor trust status of a qualified personal residence trust.

The qualified personal residence retained interest trust (QPRT) is a retained interest trust funded with a personal residence. It has substantial grantor trust implications, all arising from the reason for its creation and implementation. Treas.Reg. §25.2702-5(b). If the trust holds both a personal residence and cash, or the document allows for the sale of the personal residence during the retained interest term or conversion of the trust to a grantor retained annuity trust, this is formally referred to as a "qualified personal residence trust." Treas.Reg. §25.2702-5(c).

During the retained interest term, the trust is automatically a grantor trust. This fact is important should the residence be sold and a capital gain occur. In that event, the exclusion under the Code would apply to eliminate the first $250,000 (or $500,000 if the grantor is married) of the gain because of the grantor trust status.

After the retained term, the grantor of the trust will often desire to retain use of the trust. This is almost an automatic assumption in the case

of personal residences transferred to a QPRT. In that event, the grantor must pay fair market value rent to avoid adverse estate tax consequences while residing there. See, *e.g.,* Pvt.Ltr.Ruls. 9829002 (July 17, 1998), 9827037 (July 2, 1998). See also Rev.Rul. 70-155, 1970-1 Cum.Bull. 189; *Estate of McNichol v. Commissioner,* 265 F.2d 667 (3d Cir. 1959).

The payment of rent will be another means to transfer property to the beneficiaries without additional gift tax concerns. Ordinarily, however, the payment of rent results in taxable income to the children, who would then own the property.

If the trust is structured as a grantor trust after the retained term expires, the payment of rent will be between the grantor and the grantor trust. Under the reasoning of Rev.Rul. 85-13, 1985-1 Cum.Bull. 184, this is a non-recognition event for income tax purposes. As a result, the grantor will pay rent — a tax-free transfer to the remaindermen of the QPRT — without having that rent treated as taxable income.

The importance of Rev.Rul. 85-13 to the grantor trust strategy is much like the importance of Code section 2056 to the marital deduction. It is the pivotal authority underpinning the planning strategies. The ruling, in essence, reflects the Service's view that transactions between a grantor, individually, and that person's grantor trust are to be ignored. Rev.Rul. 85-13 did not accept *Rothstein v. United States,* 735 F.2d 704 (2d Cir. 1984), which had held to the contrary.

iii. Postmortem use of grantor trusts in the credit shelter trust context.

The grantor trust strategy should be considered in credit shelter trusts. This provides tremendous and important planning opportunities. The concept behind the credit shelter trust is to allow the $3,500,000 amount in 2009 (reduced by any lifetime use) to pass free of estate tax at both the passing of the first spouse and the subsequent passing of the surviving spouse. The $3,500,000 amount will pass to the credit shelter trust free of estate tax at the first spouse's death because of the unified credit. Upon the death of the surviving spouse, the credit shelter trust will pass free of estate tax because it is not part of the surviving spouse's estate. In fact, as long as the credit shelter trust remains in existence, it will not be subject to estate taxes.

If the spouse is a beneficiary of the credit shelter trust, this does not preclude the spouse from acting as trustee. However, if the spouse acts as trustee, the standard of principal distributions needs to be limited to an ascertainable one relating to health, support, maintenance, or education. Further, the spouse should be given no express general power of appointment and should not have the possibility of using the funds to discharge a legal obligation of support or other creditor obligation.

Ideally, the goal of a credit shelter trust after the first spouse has passed away and the trust has been created is to accumulate wealth in the trust that will be passed on free of estate tax at the surviving spouse's passing. To the extent the trust generates income and the income taxes are paid out of non-trust assets, *e.g.*, by the surviving spouse out of his or her assets, this increases the estate tax free amount in the credit shelter trust at the cost of decreasing the estate taxable amount held by the surviving spouse. This is an excellent result from an estate tax reduction perspective.

The strategy involves the surviving spouse acting as trustee of this type of trust. If the surviving spouse is the trustee and a beneficiary, the question is whether the literal language of Code section 678 is met:

> "A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
>
> (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself."
>
> Treas.Reg. section 1.678(a)-1(b) provides that "[s]ection 678 treats a person as an owner of a trust if he has a *power* exercisable solely by himself to apply the income or corpus for the satisfaction of his legal obligations." [Emphasis added.]

The issue arises in the typical language in the credit shelter trust providing the surviving spouse, as trustee, with the right to distribute income or principal to the surviving spouse if needed for that spouse's "health, support, or maintenance." Absent a savings clause, the power to pay pursuant to this standard would encompass that spouse's creditors and fall within the language of the above-cited regulation. Further, the right to distribute income or principal to oneself, even if limited to an ascertainable standard, is perhaps the power to vest the corpus or income in oneself within the meaning of §678.

There are arguments to the contrary. One is that if the standard is ascertainable, the person does not have the power, exercisable *solely* by himself or herself, to vest the trust property in himself or herself. The nature of an ascertainable standard, after all, is that its exercise depends on objective factors outside the control of the holder. Another argument to the contrary is that the power is not exercisable unless the standard of distribution is met, *i.e.*, the spouse is in need of the funds pursuant to that standard and the trustee must distribute. In that event, although the trust would be a grantor trust, it would also arguably be included in the gross estate under Code section 2033 (in a bizarre sort of way). Although the surviving spouse can act as trustee of a credit shelter trust with an ascertainable standard relating to health, support, or maintenance (or a related standard) without running afoul of the §2041 power of appointment rules, there is one important caveat. If the standard of distribution is met and the trust is drafted in a way that would mandate the

distribution of funds if the standard is met, arguably the funds are de facto distributable to the spouse and included in that spouse's gross estate under either §2041 or §2033 whenever the actual need is present. Not to worry, however; the Service has not yet made this argument.

The issue also becomes important if the credit shelter trust is holding a personal residence. In that situation, the need to be a grantor trust is highlighted by the residence exclusion under the Code, which states that "Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two years or more." See Rev.Rul. 66-159, 1966-1 Cum.Bull. 162; Pvt.Ltr.Rul. 9026036 (June 29, 1990), *rev'd in part by* Pvt.Ltr.Rul. 9321050 (May 28, 1993). A non-grantor trust would not be entitled to this exclusion. A grantor trust should, however, be entitled to the exclusion.

iv. Grantor retained annuity trusts (GRATs)

GRATs are grantor trusts masquerading as pure transfer tax strategies. Since the GRAT permits payment of both income and trust principal to satisfy the annuity payments the grantor has retained, the GRAT will be treated as a grantor trust for income tax purposes. This means the grantor is taxed on income and realized gains on trust assets even if these amounts may be greater than the trust's annuity payments. This further enhances this tool's effectiveness as a family wealth-shifting and estate-tax-saving device. In essence, the grantor is effectively allowed to make tax-free gifts of the income taxes that are attributable to assets backing the remainder beneficiary's interest in the trust.

v. Sale to a grantor trust.

The sale is structured by the owner of the asset, which may be a business interest. He or she initially establishes a trust that is effective as a grantor trust for income tax purposes but that is not controlled by the business owner or otherwise subject to an estate tax taint. The heart of the transaction is a sale between the grantor and a third party — *e.g.*, the grantor's family irrevocable trust. This trust will benefit the grantor's beneficiaries. The adult children are often designated as the original trustees of the trust. As a grantor trust for income tax purposes, there will be no recognition of gain on the sale of the asset to the trust. Thus, the difference between the grantor's basis in the asset and the sales price to the trust will not currently be taxed as a capital gain. Further, the grantor will pay income taxes on the income received by the trust because of the assets the trust owns. In this regard, it is as if for income tax purposes the grantor still owns the assets sold to the trust. Importantly, the payment by the grantor of those taxes will not, under current law, constitute a gift to the trust.

B Drafting a Grantor Trust

1. Importance of Structuring the Provision

The practitioner should carefully consider which power to give to the grantor or other individual in order to make the trust a grantor trust. This consideration is particularly important to avoid adverse estate tax treatment of the trust.

a. Example: Estate tax adversity by mistake

For example a parent may wish to give $10,000 worth of S corporation stock to a §2503(c) trust for her son and may further wish to pay all of the income taxes generated by the gifted assets until the son reaches age 21. In short, the parent wants to create an effective grantor trust. The parent also desires to transfer the stock free of gift tax through use of the Code §2503(b) gift tax exclusion, to avoid having the trust subject to federal estate tax at the parent's death, and to ensure that the gift will not jeopardize the Subchapter S status of the corporation. The parent's retention of the right to revoke the entire trust would accomplish the parent's goal of causing the trust to be a grantor trust (under Code §676) but also would cause the trust to be includible in the parent's estate for federal estate tax purposes under Code §§2036 and 2038.

b. Example: Avoiding estate tax problems

Conversely, if the trust included a provision that allowed a third-party, non-adverse trustee to use trust income to pay premiums on policies of life insurance on the grantor or allowed the grantor to substitute trust property (neither of which cause inclusion of the trust assets in the grantor's estate), the trust technically would be a grantor trust under Code section 677 or section 675, thereby allowing the trust to be a permitted S corporation shareholder with all income taxes paid by the parent, and yet not be includible in the taxable estate of parent. See Pvt.Ltr.Ruls. 8852003 (Dec. 30, 1988), 8823112 (Jun. 10, 1988), 8926019 (Jun. 30, 1989).

2. Why Boilerplate.

For planning purposes, the first decision by the client and practitioner is whether a grantor trust is desired. Once that decision is made in the affirmative, the trust needs to be so structured, presumably with minimal discussion as to "the correct grantor power" with the settlor.

As long as **no real dispositive** powers are created by the grantor trust powers, the client is not all that interested in the road to grantor trust status. They just want it to work. In this way, the provision becomes boilerplate.

3. Which "Bad" Power to Use.

The issue is what power to use to make the trust a grantor trust. No one power is better than another. Either the trust has a power that causes it to be a grantor trust, or it does not have that power. Having more than one grantor trust power does not make it more of a grantor trust. However, as planners, we tend to over-intellectualize all planning areas, and this is one that has been so tortured.

a. 675(4) Powers

The provision most favored as a grantor trust provision, until recently, was the section 675(4)(C) power "to reacquire the trust corpus by substituting other property of an equivalent value." There are rulings that support the conclusion that this power, alone, is sufficient to create a grantor trust. See Pvt.Ltr.Ruls. 9352017 (Dec. 30, 1993), 9239015 (Sept. 25, 1992).

Recently, there has been propounded the argument that this power may create a retained interest subject to estate tax inclusion under Code section 2036(a)(1) or section 2038. Specifically, because the power is retained in a non-fiduciary capacity, it looks like a retained power to alter or designate the beneficial interests under those sections.

However, that argument is tenuous at best. The Service discussed the argument recently in Revenue Ruling 2008-22 and provided guidelines as to how to avoid it where the substitution power was held by the grantor, but not as trustee. In that setting, the Service ruled:

"A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income. "

If it becomes a concern, section 675(4) allows for the power to be exercisable "in a nonfiduciary capacity by any person without the approval of any person in a fiduciary capacity." Arguably, the power can be vested in one other than the grantor to put the property back in the grantor by having other property held by the grantor substituted into the trust.

i. Drafting Example

That power cannot be used in a QPRT since the regulations provide that in a QPRT the residence cannot be reacquired by the grantor. Treas.Reg. §25.2702-5(c)(9). (However, a distribution upon expiration of the retained term to another grantor trust pursuant to the provisions of the instrument is permissible.) A different grantor trust power must be used.

ii. 675(4) Powers and QPRTs

One possibility is to use the power to borrow the corpus without adequate security (and make sure that the trustee does not have the power to lend the property without adequate security). Code §675(4).

b. Power to Add

Another grantor trust power that is currently used by practitioners is the power in the trustee or other party (who is a non-adverse party) to add charitable beneficiaries. Under section 674(b)(5), the ability of a non-adverse party to expand the class of beneficiaries is a grantor trust power.

Code §672(a) defines "adverse party" as any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

A "nonadverse party" is simply defined as "any person who is not an adverse party." Code §672(b).

i. *Drafting Example: 674 grantor trust power*

Trust Protector

This Article shall apply only during my life.

13.1 *Designation.* I name _____ as the Trust Protector. Each Trust Protector at any time acting shall have the power by written instrument to designate an individual (other than me, my spouse, or an Adverse Party) as his or her successor as Trust Protector. If at any time no individual is acting or designated pursuant to the preceding sentence and able and willing to act, then the first of following who is able and willing to act shall be Trust Protector:

(a) _____;

(b) _____;

(c) _____;

(d) An individual appointed by the trustee (other than me, my spouse, or an Adverse Party).

13.2 *Resignation.* A Trust Protector may resign at any time by signed notice to the trustee.

13.3 *Power of Trust Protector.* The Trust Protector shall have the power, acting in a non-fiduciary capacity and without the consent or approval of the trustee, any beneficiary or other Adverse Party, any court, or any other person, at any time and from time to time by written instrument delivered to the trustee, to designate any one or more Charities or spouses of mine or of any beneficiaries as additional beneficiaries ("Additional Beneficiaries") of the Lifetime Trust. The Trust Protector (or any successor Trust Protector) may from time to time amend or revoke any designation of Additional Beneficiaries at any time by written instrument delivered to the Trustee.

13.4 *Distributions.* The trustee of the Lifetime Trust may pay to any one or more Additional Beneficiaries as much of the income and principal of the Lifetime Trust as the trustee considers advisable. The trustee's decision to make or not to make a distribution pursuant to the preceding sentence of this paragraph shall be conclusive and binding on all beneficiaries.

13.5 *Qualification.* Notwithstanding any other provision, only a Nonadverse Party may act as a Trust Protector. If an individual acting as the Trust Protector becomes an Adverse Party, that individual shall immediately cease to act as Trust Protector.

13.6 *Release by Trust Protector.* The Trust Protector at any time acting may by written instrument delivered to the Trustee irrevocably release the power granted the Trust Protector under this Article. If the Trust Protector releases such power, such power shall thereafter no longer be exercisable by the Trust Protector or any successor Trust Protector.

13.7 *Termination.* Upon the earlier to occur of my death and a release pursuant to the preceding paragraph by the Trust Protector of the power granted the Trust Protector under this Article, all Additional Beneficiaries designated pursuant to this Article shall cease to be beneficiaries of the Lifetime Trust.

13.8 *Compensation.* The Trust Protector shall receive no compensation for acting as Trust Protector.

13.9 *Exoneration of Trust Protector.* A Trust Protector acting in good faith shall not be liable for any act or omission.

Article 14
Definitions

14.1 *Adverse Party*. An "Adverse Party" shall have the same meaning as in Code §672(a).

IX. Section 2503(c) Minor's Trust

A. The Easiest Trust Format to Make Gifts to Minors.

Section 2503(c) of the Internal Revenue Code permits a statutory exception to the general rule that a gift to a trust will be, at least in part, a gift of a future interest. The exception permits the full amount of a transfer for the benefit of a person under age 21 to be considered a gift of a present interest, and therefore potentially to qualify for the annual exclusion. 2503 (c) trusts continue in popularity because of their simplicity, as well as their ability under many state statutes to absorb and transmogrify custodial gift arrangements.

B. Why Boilerplate?

There is a practical answer to this question. Most 2503 (c) trusts are drafted in answer to the client question of "how to leave funds to my minor children." In that regard, the client is not all that concerned about the terms of the trust, just that there be a trust. From a technical perspective, the terms of the trust are generally spelled out, by implication or express provision, by section 2503 (c). As a result, the dispositive provisions of the 2503 (c) trust are primarily boilerplate.

C. Drafting the 2503(c) Trust

Section 2503(c) trusts are easy to draft, but contain substantial dangers. In particular, unlike most trusts that practitioners draft that have constrained principal distribution provisions, these kinds of trusts cannot have limitations on the trustee's distribution authority that would constitute "substantial restraints" on distribution. Further, only one minor can be a beneficiary of the trust; and the trust must vest in that minor's estate if he or she predeceases the termination of the trust.

D. Drafting Example: Distribution Rights Under the 2503(c) Trust

Article 3
Administration of Child's Trust

The trustee shall administer the child's trust as follows:

3.1 *Payment of Income and Principal.* The trustee may use for the benefit of the child as much of the income and principal of the trust as the trustee from time to time considers desirable, adding any income not so paid in each year to principal as of the end of each tax year, except that after the child has attained age 21 the trustee shall pay all the income to the child.

3.2 *Withdrawal at Age 21.* For a period of three months after the child attains age 21, the child may withdraw as much of the principal of the trust as the child requests by written instrument delivered to the trustee. The trustee shall promptly notify the child of the withdrawal right as it accrues.

3.3 *Lifetime Withdrawal of Principal.* After the child has attained age _____, the trustee shall distribute as much of the principal to the child as the child from time to time requests by written instrument delivered to the trustee during the child's life, not exceeding in the aggregate half in value before the child has attained age _____. For purposes of this paragraph, the value of the principal shall be determined as of the time the child first exercises the right to withdraw, plus the value of any subsequent additions as of the time of addition.

3.4 *Power of Appointment at Death.* On the death of the child, the trustee shall distribute the child's trust to any one or more persons, organizations, and the child's estate as the child appoints by will, specifically referring to this power of appointment.

3.5 *Distribution on Termination.* On the death of the child, the trustee shall distribute the child's trust not effectively appointed as follows:

(a) *Any Descendant Living.* If the child has a descendant then living, *per stirpes* to the child's then living descendants; or

(b) *No Descendant Living.* If the child has no descendant then living, in shares of equal value to my then living children, except that (1) if a child of mine is not then living but any descendant of the child is then living, the trustee shall distribute the share that would have been distributed to the deceased child, if living, *per stirpes* to the child's then living descendants and (2) any share of trust property otherwise distributable to a child of mine who has not attained age _____ shall be retained by the trustee as a separate trust for the child on the terms and conditions of this trust, as if the child were the person for whose benefit this trust was originally created.

X. Drafting for Creditor Protection Concern

A. The Genesis of an Appreciated Strategy.

An interesting development is the distribution of funds to adult, well-to-do children, or, to state it another way, the distribution to adult children who are not spendthrifts. In those instances, there may be no reason to hold funds in trust, at least not for the traditional reason to protect children against their own self indulgences. However, creditors, including a child's spouse, lurk in many dark and not so dark corners of the world.

B. Drafting Creditor "Shield" Trusts.

Consider discussing with the client the use of trusts for the children, with the children as their own trustee, to provide a creditor protection shield for funds left in the trust not needed for the child's consumption, as the child determines from time to time. Note the use of the word "shield," versus "insulation." These trusts are intended to balance flexibility to the child in terms of access to the principal, with some protection against creditors, although not a complete insulation.

C. Why Boilerplate.

For planning purposes, assume the client and planner have determined that a flexible creditor protection trust for adult children is desired. Therefore, the question becomes how close to the edge can the trust be pushed. For example, can the child be trustee? If so, must the standard be a narrow one related to health, support or maintenance? Or should the standard be expanded to "best interests?" Each shift in adding more control to the beneficiary – as trustee, and then pursuant to an unascertainable standard—creates some decrease in creditor protection. How much will depend on evolving state law in this regard. And yet, this is the kind of decision that a client cannot be expected to make in an informed way. The practitioner, based on state law and knowledge of the client's family, has to recommend the format that should be used. In this way, this provision becomes boilerplate.

D. Drafting Example: (The Adult Creditor Shield Trust)

Child's Separate Trust

Any trust property allocated for a child of mine subject to the Child's Separate Trust withholding provisions shall be added to or used to fund the principal of a Child's Separate Trust for the child. The trustee shall administer each Child's Separate Trust as follows:

Section 1.01 Discretionary Payment of Income and Principal. During the child's lifetime, the trustee may pay to the child so much of the income and principal as the trustee from time to time considers necessary for the health, education, support, maintenance in reasonable comfort, welfare, or best interests of the child. Any income not so paid in each tax year shall be added to principal at the end of each tax year.

Section 1.02 Power of Appointment at Death. On the death of the child, the trustee shall distribute the principal to any one or more persons or organizations (including the child's estate) as the child appoints by Will, specifically referring to this power of appointment.

Section 1.03 Distribution on Termination. On the death of the child, the trustee shall distribute the Child's Separate Trust not otherwise effectively appointed as follows:

(a) Any Descendant Living. If the child has any descendant then living, to the child's then living descendants, *per stirpes*; or,

(b) No Descendant Living. If the child has no descendant then living but I have any descendant then living, to the trustee to allocate in shares of equal value for my then living children, subject to the Child's Separate Trust withholding provisions hereof; provided that if a child of mine is not then living but a descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the child, if living, *per stirpes* to the child's then living descendants.

E. Cutting Back the Creditor Protection Trust to a Creditor "Annoyance" Trust

Further, be sure to coordinate the trustee provision so that a child at a certain age can get control over this creditor protection trust, in the child's capacity as a fiduciary.

1. Drafting Example: Child as Trustee of Creditor Annoyance Trust

Section 1.04 Trustee of Child's Separate Trust. Notwithstanding any other provision, upon attaining age thirty (30), each child of mine shall have the following powers with respect to the Child's Separate Trust established for the child's benefit under this instrument:

(i) Sole Trustee. The child shall have the right to appoint himself or herself as trustee.

(ii) Remove and Appoint. The child may remove any trustee at any time by a signed instrument, but only if, on or before the effective date of removal, a successor trustee has been appointed by that child or at least one trustee will continue to act after the removal.

XI. Drafting for Continuous Loop GST Planning (RAP)

A. What GST Means for the Drafter.

The goal is to create trusts for the benefit of children, grandchildren, and further descendants for as long as permitted under the local rule against perpetuities.

From a practical concern, the trusts are structured a certain way. At the client's death, if GST planning is used, the client's available GST exemption amount is allocated for the descendants *per stirpes* to be held in GST Separate Trusts. Thus, if all of the children are then living, a GST Separate Trust will be established for each child, who will be the primary beneficiary of his or her trust.

The GST Separate Trusts permit discretionary distributions of income and principal to the primary beneficiary and the primary beneficiary's descendants.

1. Who are the Beneficiaries?

Assets of the GST Separate Trusts are exempt from GST tax as long as they remain in trust. They will not be subject to estate or gift tax until distributed to a beneficiary and then given away during life or included in the beneficiary's estate.

2. Typical Terms.

The GST Separate Trusts are designed to hold the share of any descendant, whether the descendant is a child, grandchild, or more remote descendant. Thus, if a child predeceased the client leaving two surviving children, upon the client's death the child's share of the assets allocated to the GST Separate Trusts would be held in separate GST Separate Trusts for the child's two children.

3. How Long will It Go.

A GST Separate Trust provides the primary beneficiary with significant control to determine the distribution of the GST Separate Trust's assets at the primary beneficiary's death. The primary beneficiary is given a broad special power of appointment. Thus, the primary beneficiary could exercise this power of appointment to direct the distribution of the assets to any one or more persons or organizations (other than the primary beneficiary, the primary beneficiary's estate, the creditors of the primary beneficiary, or the creditors of the primary beneficiary's estate) and cause the termination of the GST Separate Trust. Alternatively, the primary beneficiary could exercise the power of appointment to direct that the GST Separate Trust's assets pass to different GST trusts for future generations (thus providing the primary beneficiary with the opportunity to essentially rewrite the terms of the GST trusts at death). As a third alternative, the primary beneficiary could fail to exercise the power of appointment, in which case the assets of the primary beneficiary's GST Separate Trust would be allocated at the primary beneficiary's death for his or her descendants *per stirpes*, to be held in GST Separate Trusts on similar terms.

B. Why Boilerplate?

The GST trust is established in most instances with the goal of preserving assets from estate tax from generation to generation, and also adding an element of creditor protection. On the other hand, most clients do not desire to divest the younger generation from control. Therefore, in most instances, the GST trust will be drafted in the most flexible way for the children (for instance, and thereafter future generations) to manage and control and obtain use of the assets, without running afoul of the federal tax laws on inclusion in the gross estate. In this way, most of the form for a GST trust will have standard provisions, and in this way, the form too becomes boilerplate.

C. Coordination with State Law.

The GST Separate Trusts (or the GST Single Fund Trust) can continue in existence in perpetuity depending on relevant state law. As long as the assets are held in the GST Separate Trusts, no estate taxes will be imposed as each generation dies and no GST taxes will be imposed

(assuming that GST exemption was properly allocated to the trusts). Accordingly, drafting has to be coordinated with the state specific non-perpetuities provision.

D. *Drafting Example: Drafting the Best Provision GST Trust*

As important, because each trust is intended to continue from generation to generation, the question is how to draft, efficiently, the correct generation skipping trust for each generation. For example, when a G2 trust terminates and is distributable to a G3, to be held under the same terms, how is the loop drafted without having to draft a new trust for G3, and then again G4?

Solution: Note the reference in the first paragraph to, "Any trust property allocated for a descendant of mine subject to the GST Separate Trust," and then, in the termination,"[o]n the death of the primary beneficiary, the trustee shall, subject to the GST Separate Trust withholding provisions, allocate….."

Article 4
GST Separate Trusts

Any trust property allocated for a descendant of mine subject to the GST Separate Trust withholding provisions shall be added to or used to fund the principal of a GST Separate Trust for the descendant (the "primary beneficiary"). The trustee shall administer each GST Separate Trust as follows:

4.1 *Discretionary Payment of Income and Principal.* The trustee may pay as much of the income and principal to any one or more of the primary beneficiary and the primary beneficiary's descendants as the trustee from time to time considers necessary for the health, maintenance in reasonable comfort, or education of each of them. I recommend that the trustee make no payment of income or principal to a child of mine if any part of the Child's Separate Trust for that child is reasonably available for those purposes. The trustee may make the payments in equal or unequal shares, taking into account the present and prospective needs of those persons. Any income not so paid in each year shall be added to principal at the end of each year.

4.2 *Power of Appointment at Death.* On the death of the primary beneficiary, the trustee shall distribute the GST Separate Trust to any one or more persons and organizations (other than the primary beneficiary, the primary beneficiary's estate, the creditors of the primary beneficiary, or the creditors of the primary beneficiary's estate) as the primary beneficiary appoints by will, specifically referring to this power of appointment.

4.3 *Allocation on Termination.* On the death of the primary beneficiary, the trustee shall, subject to the GST Separate Trust withholding provisions, allocate the GST Separate Trust not effectively appointed as follows:

(a) *Any Descendant Living.* If the primary beneficiary has a descendant then living, *per stirpes* for the primary beneficiary's then living descendants; or

(b) *No Descendant Living.* If the primary beneficiary has no descendant then living but I have a descendant then living, *per stirpes* for the then living descendants of the primary beneficiary's nearest lineal ancestor who was a descendant of mine and who has a descendant then living, or if no such descendant is then living, *per stirpes* for my then living descendants.

Add a waiver of the RAP.

No Rule Against Perpetuities. I intend that each trust established under this instrument shall be a Qualified Perpetual Trust under State law and shall not be subject to the Rule Against Perpetuities. The power of the trustee to sell, lease, or mortgage assets shall be construed as enabling the trustee to sell, lease, or mortgage trust property for any period beyond the Rule Against Perpetuities. If assets that would not qualify as part of a Qualified Perpetual Trust would otherwise be added to any trust established under this instrument, the trustee shall segregate those assets and administer them as a separate trust identical to the one to which the assets would have been added, except that, despite any other provision, 21 years after the death of the last to die of all of the beneficiaries living at my death, each such separate trust then held under this instrument shall be distributed to the income beneficiaries in the proportions in which they are entitled to share the income or, if their interests are indefinite, to the income beneficiaries in equal shares.

XII. Can the QTIP Revocable Trust Format be Considered Boilerplate for Wealthy Married Individuals?

A. Too Many Choices?

Our Western philosophy is that "If Enough is Good, More than Enough is Better." Does this apply to selection of provisions in documents. Is having 10 choices better than having 1 choice? Perhaps yes; perhaps no.

Having choices may be fine if the marginal benefit to the client of being able to pick a particular format and provision is greater than the marginal aggravation (cost + pain of thought process). This then brings up the question of whether a typical married couple with estate tax issues can have a Pour-Over Will/revocable living trust plan, represented by predetermined formulas and boilerplate provisions, with minimal decision-making.

B. Why Boilerplate.

If the spouse is trustee of the testamentary trusts, assuming the spouse is capable of acting and appropriate to act in this role, the remaining format of the document can be structured in an

extremely tax efficient, creditor protection, and flexible way, such that the decisions to be made are minimal. That is, the document becomes the proverbial 95% boilerplate, THOUGH the provisions, substance, and result of the provisions should be discussed with the client. Other variables:

1. A client's decisions on estate planning documents is often a reflection of the planner's questions and discussion. The planner frames where the document ends up.

2, There is no discussion with the client as to which marital deduction formula to use, or even whether to incur a bit of state inheritance tax at the first spouse's passing to maximize the credit shelter trust. The existence of the credit shelter trust, and the marital trust, are fait *accomplis,* as are the creditor protection trusts for the children, and the trustee pattern. In a sense, the document drafting becomes almost entirely boilerplate. Attachment 1 contains such a document, with annotations.

Attachment 1: The Boilerplate Trust

The following form is drafted to facilitate client understanding.

Many forms subsequent to 1982 provide sophisticated but complicated formulas located in the main text of the document. A client reading the document would have little understanding of the technical terms, and the excruciating detail often confuses a client or, worse, discourages the client from reviewing the dispositive provisions.

To avoid that result, the dispositive provisions of the forms are short and understandable in their approach. For example, to create the credit shelter amount, the forms provide merely that the "tax-sheltered amount" is to be distributed to the family trust and the residue to the spouse or to a trust for the spouse. The complicated provisions that define and adjust this concept are contained in the back of the document in a separate article. Thus, in explaining the documents to the clients, the attorney need say only that the "tax-sheltered amount" is generally the applicable exclusion amount with possible adjustments. What are those adjustments? The adjustment clause is contained toward the back of the document in a separate article.

For plans funded with retirement assets, a fractional formula should be used (versus the following pecuniary credit shelter formula).

ANNOTATED REVOCABLE TRUST WITH QTIP MARITAL TRUST FORM

Annotated Credit Shelter Lead v2.d

JOHN DOE TRUST

I have signed this trust on this _____ day of _____, 2009. I**, JOHN DOE**, have transferred ten dollars to myself as trustee. The trustee shall administer that asset and any other assets the trustee receives (the "trust property") as follows:

COMMENT

The establishment clause provides that the client is transferring property to the trust. One of the requirements for the creation of a valid trust under the common law was the existence of some property subject to the trust. See also Section 401 of the Uniform Trust Code ('UTC")[1], which provides that a trust is not created until it receives some property, which need not be substantial and need not be received contemporaneously

[1] The UTC is primarily a default statute. The provisions of the UTC that correspond to the trustee's powers and discretions are given here for comparison. Where the provisions differ, the provisions of the form would control over the provisions of the UTC. However, in states that have enacted the UTC, there are items that are not subject to override by the terms of the trust. See Section 105(b). Where applicable, these are noted in the succeeding comments. The version of the UTC that is enacted in a particular state may vary from the model form to which these materials refer. The version of the UTC referred to in these materials is the UTC last revised or amended in 2005, as listed on the NCCUSL website as of February 26, 2008.

with the signing of the document. The establishment clause also indicates that any other assets received by the trustee will be subject to the terms of the trust.

Article 1
Introduction

1.1 **Family.** My "spouse" is Jane Doe. I have three (3) children now living, namely:

James Doe, born January 1, 2000;
June Doe, born January 1, 2002; and
Josiah Doe, born December 31, 2007.

I intend to provide for all my children, including any born or adopted in the future.

1.2 **Name of Trust.** The name of this trust is the **JOHN DOE 2009 TRUST**.

1.3 **Right To Amend or Revoke.** I may amend or revoke this trust at any time during my life by delivering an instrument (other than my Will) that is signed by me to the trustee. If I revoke this trust, the trustee shall deliver the trust property to me or as I direct.

COMMENT

Paragraph 1.1 names the spouse of the client as well as the client's children. The document specifically provides that children, whether born now or in the future, are covered by the term "children" in the document. "Child" is further defined in Paragraph 14.2. The term "spouse" is used throughout the document to refer to the grantor's husband or wife.

Paragraph 1.2 names the trust. Additional assets may be transferred to the trust by titling them in this name. For example, client John Doe would re-title his assets in the name: "John Doe, as trustee of the John Doe Trust dated _____, 2009." If the trust is amended in the future or if a successor trustee replaces the original trustee, assets held in the name of the trust need not be re-titled.

The grantor's retained right to modify or revoke the trust at any time under Paragraph 1.3 provides for flexibility in changing the terms of the trust. The right to revoke, as well as other provisions in the document, such as the grantor's right to use the property, (1) cause the trust to be treated as a grantor trust for income tax purposes under Code §§671 – 677 during the grantor's life and (2) will cause the trust property to be included in the grantor's estate for tax purposes under Code §§2036 and 2038. Thus, titling assets in the revocable trust during life does not change the grantor's income or estate taxation.

Under the common law, a trust was considered irrevocable unless the grantor reserved the power to revoke. Many states follow this common-law principle. Section 602(a) of the UTC reverses the common-law presumption, but only for trusts created after the effective date that the UTC is adopted in the state. Under the UTC, the grantor may amend or revoke a trust created after the UTC is adopted unless the terms of the trust expressly provide that the trust is irrevocable.

Under the law of some states, if a grantor reserved the right to amend a trust in a particular way, the trust could only be amended by that means. Section 602(c)(2) of the UTC changes this principle also. If the terms of the trust do not provide a method of amending the trust, or if the method provided is not expressly made exclusive, a trust may be amended (A) by a later will or codicil that expressly refers to the trust or specifically devises property that would otherwise have passed according to the terms of the trust, or (B) by any other method manifesting clear and convincing evidence of the grantor's intent.

The amending clause in this form does not provide an exclusive method of revoking or amending the trust, but does expressly state that the trust cannot be revoked or amended by will. The authors believed that if an asset was titled in the name of the trust, a will should not control its passing. Also, excluding revocation or amendment by will eliminates any potential legal argument that a will's general residuary clause would somehow affect the trust.

Article 2
Lifetime Trust

During my life, the trustee shall administer the trust property as the "Lifetime Trust" for my primary benefit as follows:

2.1 **Distributions During My Life.** Unless I am incapacitated, the trustee shall pay to me as much of the income and principal as I request at any time. If I become incapacitated, then while I am incapacitated, the trustee may pay:

(a) **Payments For Me.** As much of the income and principal to me as the trustee considers advisable for my health, maintenance in reasonable comfort, or best interests;

(b) **Payments for Dependents.** As much of the income and principal to any person who is legally dependent on me as the trustee considers necessary for the person's health, maintenance in reasonable comfort, or education; and

(c) **Exclusion Gifts.** An Exclusion Gift or Medical Exclusion Gift to any descendant of mine as the trustee considers advisable.

2.2 **Determination of Incapacity.** I shall be incapacitated whenever I am unable to give prompt and intelligent consideration to financial affairs or whenever a court has appointed someone to manage my financial affairs. My inability to give prompt and intelligent consideration to my financial affairs shall be made in writing, signed by my physician, and, if my spouse is then living and able to make decisions, by my spouse, and delivered to the trustee. The trustee may rely conclusively on that writing.

COMMENT

During the lifetime of the grantor of the trust, the trust is administered for the grantor's benefit under the terms set forth primarily in Article 2.

<u>Paragraph 2.1</u>:

Under Paragraph 2.1 the grantor can withdraw assets from the trust at any time and for any reason, as he or she determines appropriate. In addition, Paragraph 2.1 distinguishes between discretionary payments made to the grantor and those made to dependents, such as a spouse or children. Payments to the grantor are made pursuant to a non-ascertainable standard, while those to third parties are ascertainable. The distinction is important to prevent a spouse who becomes a successor trustee from inadvertently holding a general power of appointment.

The standard for the grantor includes what is "advisable" for the grantor's best interests. The standard for third parties is limited in two respects: (1) the purposes for a distribution are limited to health, maintenance in reasonable comfort, and education, all ascertainable under the Code, and (2) the trustee's consideration is expressed in terms of what is necessary rather than what is advisable. See Treas. Reg. §20.2041-1(c)(2), which states that a power of invasion is limited by an ascertainable standard if the extent of the holder's duty to exercise and not to exercise is reasonably measurable in terms of his needs for health, education or support. See also paragraph 10.1 of Article 10, which prevents a successor trustee from using trust property to discharge a legal obligation of support.

If the grantor becomes disabled, a successor trustee can also make annual exclusion gifts under Code Section 2503(b) and tuition and medical gifts under Code Section 2503(e) to the grantor's descendants. This power is useful when an annual gift program is an important element of a client's estate plan. The trustee's power to continue the program assures the family that the tax benefits of the gifts will continue even if – as seems often to be the case – the power to make gifts has been overlooked in the client's durable power of attorney. Code Section 2035(e) treats gifts from grantor trusts as though made directly by the grantor, avoiding inclusion under Sections 2035 and 2038. Annual exclusion and tuition and medical gifts are defined at Article 14, Paragraph 14.5.

<u>Paragraph 2.2</u>:

Paragraph 2.2 provides a definition of "incapacity" for purposes of determining when the grantor will not be able to act as trustee. The determination focuses on the grantor's inability to give prompt and intelligent consideration to financial affairs. The client is free to establish any method of determining incapacity. In this form the grantor's physician, and the grantor's spouse if able to act, make the determination.

Pursuant to the Health Insurance Portability and Accountability Act of 1996 (HIPAA), Pub.L. No. 104-191, 110 Stat. 1936, final regulations have been promulgated at 45 C.F.R. pts. 160 and 164 entitled "Standards for Privacy of Individually Identifiable Health Information" that are commonly known as the Privacy Rule. The Privacy Rule generally prohibits a physician from releasing any information about the grantor's medical condition, including a determination of the grantor's capacity, without the grantor's authorization or the authorization of the grantor's "personal representative" as defined in the Privacy Rule.

Under the Privacy Rule, the grantor may not be able to pre-authorize the release of medical information by inserting a HIPAA waiver in the trust instrument. The Privacy Rule sets forth very specific requirements for a valid waiver, including the requirement that an authorization for use or disclosure of protected health information may not be contained with any other document to create a compound authorization (with certain exceptions for research studies and other special circumstances). 45 C.F.R. §164.508(b)(3).

However, the grantor could sign a separate HIPAA waiver at the time the grantor signs the trust, authorizing the release of the grantor's medical information for purposes of determining the grantor's capacity to act as trustee.

If the grantor does not authorize a release of medical records, under the Privacy Rule a person who has authority under applicable law to act on behalf of an individual in making decisions related to health care is the individual's "personal representative" and may authorize the release of medical information, at least for purposes relevant to the health care agent's responsibilities. 45 C.F.R. §164.502(g)(2). Thus, if the grantor did not authorize the release of the grantor's medical information for purposes of determining the grantor's capacity to continue to act as trustee, the grantor's agent under a power of attorney for health care may be able to authorize the release of such information.

However, the Privacy Rule creates some doubt about the ability of an agent under a power of attorney for health care to authorize the release of medical information for purposes of determining the ability of the grantor to continue to act as trustee. 45 C.F.R. §164.502(g)(1) provides that the health care provider must treat the personal representative as the individual, except as provided in §§164.502(g)(3) (dealing with minors) and 164.502(g)(5) (discussed below). Thus, 45 C.F.R. §164.502(g)(1) would, at first blush, appear to give the health care agent the power to request medical information for any reason, just as the grantor could release the grantor's medical information for any reason. However, 45 C.F.R. §164.502(g)(2) provides:

> **If under applicable law a person has authority to act on behalf of an individual who is an adult or an emancipated minor in making decisions related to health care, a covered entity must treat such person as a personal representative under this subchapter, with respect to protected health information relevant to such personal representation. [Emphasis added.]**

It is possible that a health care provider would release the grantor's medical information to the grantor's health care agent when necessary for the agent to make medical decisions, but withhold the same information when necessary to determine wither the grantor can continue to act as trustee. In the latter case the information may not be relevant to the health care agent's personal representation of the grantor under the health care agency.

45 C.F.R. §164.502(g)(5) potentially imposes another obstacle to the health care agent's ability to authorize the disclosure of medical records for purposes of disqualifying the grantor as trustee. That section provides:

> **(5) Implementation specification: abuse, neglect, endangerment situations. Notwithstanding a State law or any requirement of this paragraph to the contrary, a covered entity may elect not to treat a person as the personal representative of an individual if:**
>
> **(i) The covered entity has a reasonable belief that:**
>
> **(A) The individual has been or may be subjected to domestic violence, abuse, or neglect by such person; or**
>
> **(B) Treating such person as the personal representative could endanger the individual; and**

(ii) The covered entity, in the exercise of professional judgment, decides that it is not in the best interest of the individual to treat the person as the individual's personal representative.

Under some circumstances the health care provider might believe that releasing the grantor's medical information in order to permit a successor trustee to assume control of the grantor's property might endanger the grantor and not be in the grantor's best interests.

An alternative approach is to provide in the trust that the grantor will be deemed to be unable to act as trustee if an inquiry into the grantor's capacity is made and the grantor refuses to authorize the release of medical information.

Article 3
Gifts at My Death

On my death, the trustee shall distribute the following gifts from the trust property:

3.1 **Gifts of Tangible Personal Property**. The trustee shall distribute tangible personal property as I direct by any instrument signed by me. "Tangible personal property" means all personal and household effects, jewelry, automobiles, collections, and other tangible personal property that I own at my death or that is then included as part of the trust property (including insurance thereon). I may amend or revoke the written instrument at any time. Any subsequent instrument shall control to the extent it conflicts with prior ones. Any decisions made in good faith by the trustee in distributing tangible personal property shall not be subject to review, and the trustee shall be held harmless from any cost or liability as to those decisions. I shall be deemed to have left only those written instruments that the trustee is able to find after reasonable inquiry within 60 days after my death.

3.2 **Gifts of Remaining Tangible Personal Property.** I give all tangible personal property not otherwise effectively disposed of to my spouse, if my spouse survives me, or if my spouse does not survive me, in shares of equal value to my children who survive me (to the exclusion of the descendants of any child who does not survive me), to be divided among them as they agree or, if they cannot agree within 60 days after my death, as the trustee determines.

3.3 **Gifts if Spouse Survives.** If my spouse survives me, I make the following gifts:

(a) **Family Trust.** I give the tax-sheltered gift to the trustee to hold as the Family Trust.

(b) **Marital Trust.** I give the balance of the trust property to the trustee to hold as the Marital Trust.

3.4 **Gifts if Spouse Does Not Survive.** If my spouse does not survive me, I make the following gifts:

(a) **Any Child Under Age 25.** If any child of mine who survives me is under age 25 at my death, I give the balance of the trust property to the trustee to hold as the Children's Single Fund Trust; or

(b) **All Children Over Age 25.** If there is no surviving child of mine who is under age 25 at my death, I give the balance of the trust property to the trustee to allocate in shares of

equal value for my surviving children, provided that (1) if a child of mine does not survive me but any descendant of the child survives me, the trustee shall distribute the share that would have been allocated for the deceased child, if living, *per stirpes* to the child's descendants who survive me, and (2) any allocation for a living child of mine shall be subject to the Child's Separate Trust provisions.

3.5 **Survivorship.** Only persons, other than my spouse, living on the 30th day after the day of my death shall be deemed to have survived me for purposes of this Article. My spouse shall be deemed to have survived me if (a) I am the first to die, without regard to the length of survivorship, or (b) the order of our deaths cannot be proved.

COMMENT

Article 3 describes gifts on the grantor's death. The wording avoids lengthy and complicated tax formula language in order to describe a disposition understandable to the client. Accordingly, descriptive terms that the client can understand, such as "tax-sheltered gift" (referring to the maximum amount that can be shielded by the unified credit and other available credits), are used in Article 3 and then defined at length at the end of the document.

Paragraphs 3.1 and 3.2:

Paragraph 3.1 distributes tangible personal property as directed by the grantor during the grantor's lifetime. This paragraph provides the grantor considerable flexibility in changing the disposition without formally amending the trust. This flexibility would be impossible if the tangible personal property were disposed of under the will. The article defines the term "tangible personal property" and protects the trustee in distributing this property pursuant to the grantor's direction.

Paragraph 3.2 gives the remaining tangible personal property to the spouse, or if the spouse does not survive, to the children. This paragraph applies both when the directions left under Paragraph 3.1 do not dispose of everything and when there are no directions. It is assumed that the grantor intends the chattel property to pass only to children. If the client intends chattel property to benefit descendants of a deceased child, the parenthetical can be eliminated or the items can be disposed of by separate gift.

Paragraph 3.3:

Paragraph 3.3 describes the division of property if the spouse survives. In this form the trust property is divided between marital and credit-shelter portions. Note that here the basic division is expressed with two terms that are later defined in Article 14, "tax-sheltered gift" and "balance of the trust property." Relegating the complex language for these two concepts to the end of the document allows the reader to grasp the essential distribution without becoming immersed in the complex formula language.

The "balance of the trust property" is defined as the trust property remaining after the payment of taxes, debts, and specific gifts. Because taxes are excluded from the definition, there is no need to present the tax clause in temporal order. The tax clause is set forth in Article 13. This balance bears the burden of any depreciation in assets during the period of administration and also benefits from any appreciation of these same assets.

Paragraph 3.4:

Paragraph 3.4 describes the division of property if the spouse does not survive. The juxtaposition of paragraphs 3.3 and 3.4, and their relative brevity, allow the grantor to easily follow the alternative distribution, depending on which spouse dies first. In this version of the trust, if the spouse does not survive, the distribution will depend on whether there is any living child under age 25. If there is a child under age 25, then the trust property will pass to a single trust for the benefit of descendants until the youngest child is 25. If there is no child under age 25, then the trust property will immediately divide into separate trusts. The distribution language under 3.4(b) is expressed in terms of living children and descendants of deceased children, to answer a frequent question of what happens if a child dies. In this case the Latin term per stirpes serves as the best short-hand way to express the concept of a distribution by right of representation, so it is retained in reference to how property is allocated among descendants of a deceased child.

Paragraph 3.5:

Paragraph 3.5 generally imposes a 30-day survivorship requirement. In most cases, if the grantor and a descendant die as a result of a common accident, no gift will be made to the descendant. Due to tax considerations, special survivorship requirements exist for the spouse. When it is prudent to transfer assets from the wealthier spouse to the less wealthy spouse, Paragraph 3.5 should be completed so that the less wealthy spouse is deemed to have survived when there is simultaneous death. A survivorship period that lasts no more than six months from death will not be treated as a terminable interest that does not qualify for the marital deduction as long as the spouse survives the period. Treas.Reg. §20.2056(b)-3.

When drafting documents for the less wealthy spouse, consider requiring a six-month survivorship period so that if the surviving (wealthier) spouse dies within six months, the assets that would otherwise pass to the Marital Trust will be subject to estate tax in the less wealthy spouse's estate. This may permit the assets to be subject to lesser combined federal and state death taxes than would be the case if they passed to the surviving spouse.

Article 4
Marital Trust

The trustee shall administer the Marital Trust as follows:

4.1 **Mandatory Payment of Income.** Beginning with my death, the trustee shall pay all the income to my spouse.

4.2 **Discretionary Payment of Principal.** The trustee may pay to my spouse as much of the principal as the trustee considers necessary for the health or maintenance in reasonable comfort of my spouse.

4.3 **Payment of Death Taxes.** On the death of my spouse, unless my spouse directs otherwise by will or revocable trust specifically referring to this instrument, the trustee shall pay the Marital Trust death taxes.

4.4 **Power of Appointment at Death.** On the death of my spouse, the trustee shall distribute the principal not required for payment of the Marital Trust death taxes to any one or more of my descendants as my spouse appoints by will.

4.5 **Distribution on Termination.** On the death of my spouse, the trustee shall dispose of any property not required for payment of the Marital Trust death taxes, and not effectively appointed, as follows:

(a) **Any Child Under Age 25.** If any then-living child of mine is under age 25, the trustee shall hold the trust property as the Children's Single Fund Trust; or

(b) **All Children Over Age 25.** If there is no then-living child of mine who is under age 25, the trustee shall allocate the trust property in shares of equal value for my then-living children, provided that (1) if a child of mine is not then living but any descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the deceased child, if living, *per stirpes* to the child's then-living descendants, and (2) any allocation for a living child of mine shall be subject to the Child's Separate Trust provisions.

COMMENT

Article 4 describes the Marital Trust. Certain of these provisions are mandatory to allow the Marital Trust to qualify for the marital deduction. Other terms are optional and should be included or omitted as circumstances dictate.

Paragraph 4.1:

This form creates a "qualified terminable interest property" (QTIP) trust under Code §2056(b)(7). Paragraph 4.1 is a mandatory direction to distribute income. This is required by Code §2056(b)(7)(B)(ii)(I). The term "income" is not defined in the document and therefore will have the meaning accorded under local law. Discretion to distribute income or termination of the right to receive income, such as on remarriage or disability, will disqualify the trust for marital deduction purposes. Those types of provisions must not be included in the Marital Trust.

Paragraph 4.2:

Paragraph 4.2 provides for distribution of principal to the spouse in the discretion of the trustee. The scope of principal distributions can be modified to fit the client's circumstances. For example, does the grantor wish to provide any principal for the spouse? Will the spouse act as trustee? The standard in this form is limited to the health or maintenance in reasonable comfort of the spouse. In no event can one other than the spouse be the recipient of discretionary rights to principal during the spouse's life.

An ascertainable standard is not required for marital deduction purposes but is advisable if the spouse is to act as trustee and QTIP treatment is desired. For example, if a partial QTIP election is contemplated, the goal is for the non-QTIP elected portion not to be included in the spouse's estate. If the spouse is a trustee, a broad non-ascertainable standard will result in the spouse possessing a general power of appointment over the non-QTIP property under Code §2041. For the non-elected QTIP portion to be excluded from the spouse's estate, the discretion must be limited to an ascertainable standard relating to health, support, maintenance, or education. See Code

§2041(b)(1)(A). This form consistently uses ascertainable standards. If the distribution provision is broadened, then the practitioner should be sure that the spouse cannot exercise the broad powers, either because they will be vested in a co-trustee, or because the spouse is not the trustee (and does not have the right to elect to become the trustee). In this form, Paragraph 10.1 prevents a spouse from ever exercising non-ascertainable powers.

Paragraph 4.3:

Paragraph 4.3 directs that on the death of the spouse any Marital Trust death taxes are to be paid from the Marital Trust. The definition of "death taxes" is contained in Paragraph 14.4. The increase in estate taxes in the surviving spouse's estate resulting from the property being included in the surviving spouse's gross estate will be paid from the Marital Trust. See Paragraph 13.5.

Paragraph 4.4:

Paragraph 4.4, dealing with distributions at the death of the spouse, allows the spouse to appoint the Marital Trust property to any of the grantor's descendants. The class of possible recipients of the power of appointment can be narrowed or broadened without any negative tax impact at the spouse's death, as long as the spouse cannot appoint to himself or herself, his or her estate or to the creditors of himself or herself or his or her estate. If a partial QTIP election is intended, then the power of appointment should remain narrow. The spouse need not even be given a power of appointment, which is often the case in second marriages when a QTIP trust is used.

Paragraph 4.5:

Paragraph 4.5 disposes of any property not appointed or used to pay death taxes. The overall pattern is that the property is distributable to the children, but, depending on ages, the property will be distributed outright, held in separate trusts, or held in a single trust. The mode of distribution depends on the ages of the children.

First, if any child is under the age of 25, Paragraph 4.5(a) directs that the property shall be held in a "basket" trust for all of the children pursuant to Article 6. Second, if all of the children are over the age of 25, then Paragraph 4.5(b) directs that the property be distributed to each child, potentially to be held in a separate trust for his or her benefit as provided in Article 7.

Whether a trust is created for each child will depend on the child's age, as determined by the client. For example, a client may wish that no trust be required for the children if they are over age 25. In this case, the plan will distribute all of the property to the children in equal shares when the youngest is age 25. Alternatively, the client may desire separate trusts for each child until a more mature age.

Article 5
Family Trust

The trustee shall administer the Family Trust as follows:

5.1 **Mandatory Payment of Income.** Beginning with my death, the trustee shall pay all the income to my spouse.

5.2 **Discretionary Payment of Principal.** The trustee may pay to my spouse as much of the principal as the trustee considers necessary for the health or maintenance in reasonable comfort of my spouse. I recommend that the trustee not pay any principal to my spouse from the Marital Trust if principal from the Family Trust is reasonably available for the same purposes.

5.3 **Power of Appointment at Death.** On the death of my spouse, the trustee shall distribute the Family Trust to any of my descendants as my spouse appoints by will.

5.4 **Distribution on Termination.** On the death of my spouse, the trustee shall dispose of the Family Trust not effectively appointed as follows:

(a) **Any Child Under Age 25.** If any then-living child of mine is under age 25, the trustee shall hold the trust property as the Children's Single Fund Trust; or

(b) **All Children Over Age 25.** If there is no then-living child of mine who is under age 25, the trustee shall allocate the trust property in shares of equal value for my then-living children, provided that (1) if a child of mine is not then living but any descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the deceased child, if living, *per stirpes* to the child's then-living descendants, and (2) any allocation for a living child of mine shall be subject to the Child's Separate Trust provisions.

COMMENT

Paragraph 5.1:

The Family Trust is kept very simple for ease of tax planning in a decoupled situation. The spouse is entitled to all income and discretionary principal under an ascertainable standard. The grantor recommends that the trustee not pay principal to the spouse while assets remain in the Marital Trust. This is not binding, and is placed in the document to remind the trustee of the tax advantages of protecting the principal of the Family Trust from estate tax in the surviving spouse's estate.

Because the tax-sheltered gift is expressed as the largest amount that will reduce federal estate tax to zero, without regard to state death taxes, the credit shelter-marital deduction split may result in a Family Trust that is not subject to federal estate tax but is subject to state death tax. This could occur, for example, in a state that has decoupled from the federal tax and whose "exemption equivalent" is less than the federal amount of $3,500,000. In these situations the surviving spouse may be able to make a separate state-only QTIP election for part of the Family Trust. In states that do not permit such an election, the spouse may make a federal QTIP election to reduce the credit shelter amount to match whatever is exempt under state law.

To preserve this flexibility, the Family Trust is drafted to qualify for QTIP. Only the spouse is the beneficiary of the trust, and there is no lifetime power to appoint principal to third parties. Under the general severance language of paragraph 12.11 the trustee can sever the Family Trust into QTIP and non-QTIP portions. Note also the language at paragraph 12.5(c), which automatically gives the spouse of any trust otherwise qualifying for the marital deduction the right to make trust property productive.

An alternative way to plan in a decoupled state is to limit the Family Trust to the smallest amount necessary to reduce both estate and state death taxes, and to provide that the executor could make a partial election over a QTIP Marital Trust if the objective is to maximize the federal tax-sheltered amount. The advantage of this approach is that the Family Trust could include beneficiaries other than the spouse. The trust could provide that any portion of the Marital Trust for which a QTIP election is not made will pass to the Family Trust. See Treas. Reg. §20.2056(b)-7(d)(3), §20.2056(b)-7(h), Example 6, and Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992). The surviving spouse should not make the election since the effect of the election by an interested party might be considered a gift.

In Revenue Procedure 2001-38, 2001-2 C.B. 124, the Internal Revenue Service treated as a nullity a QTIP election when the effect of the election did not reduce any federal estate tax. Some practitioners have questioned whether a partial QTIP election to reduce state, but not federal taxes, would be treated as a nullity by the IRS and, if so, whether the state would also treat the election as a nullity. Although no case has arisen over this issue, one should note that the spirit of the Revenue Procedure is to benefit the taxpayer when an inadvertent or meaningless election has been made, and in any case the taxpayer has the burden of establishing that the estate qualifies for the relief. We do not believe that Revenue Procedure 2001-38 would be authority for a state to disregard a partial QTIP election that the trustee makes in order to obtain a tax benefit.

Paragraph 5.2:

Paragraph 5.2 provides for the payment of principal in the discretion of the trustee. The discretionary standard is the health or maintenance in reasonable comfort of the spouse. This is a narrow, or ascertainable, standard under Code §2041(b)(1)(A).

When the spouse is acting as sole trustee of the Family Trust, adverse estate tax consequences are avoided by using an ascertainable standard relating to health, support, maintenance, or education. If the discretion to distribute principal is broadened, the practitioner should carefully review Code §2041. If the standard is broadened to a non-ascertainable standard (one not relating to what is necessary for the spouse's health, support, maintenance, or education) and the spouse is acting as a trustee, the spouse's power to pay principal to himself or herself would be a general power of appointment under Code §2041, thus causing the Family Trust to be included in the spouse's estate and defeating the tax objective of the Family Trust. For example, the power to distribute principal for the spouse's welfare or best interests would be a general power of appointment if the spouse were acting as sole trustee and would result in the property being included in the spouse's estate when he or she dies. Accordingly, only if the spouse is not acting as a trustee should the standard for the discretionary payment of principal be broadened.

Paragraph 5.3:

Paragraph 5.3 allows the spouse to appoint the property at the spouse's death to any of the grantor's descendants. The power of appointment will be a limited (nontaxable) power under Code §2041 as long as the spouse cannot appoint to himself or herself, his or her creditors, his or her estate, or the creditors of his or her estate.

Paragraph 5.4:

Paragraph 5.4 is similar to Paragraph 4.5 of the Marital Trust and distributes any property not disposed of pursuant to the spouse's exercise of the power of appointment.

If any child is under the age of 25, then Paragraph 5.4(a) directs that the property be held in a "basket" trust for all of the children pursuant to Article 6. If all the children are over 25, then Paragraph 5.4(b) directs that the property either be distributed to each child or retained in a separate trust for his or her benefit as provided in Paragraph 7.2. Whether a trust is created for each child will depend on the client's wishes concerning the age at which the children should own property outright.

Article 6
Children's Single Fund Trust

The trustee shall administer the Children's Single Fund Trust as follows:

6.1 **Discretionary Payment of Income and Principal.** The trustee may pay as much of the income and principal to my children and their descendants as the trustee considers necessary for the health, maintenance in reasonable comfort, or education of each of them. In addition, the trustee may assist the guardian of any minor child of mine in enlarging the guardian's residence or acquiring a new residence to accommodate the minor child. The trustee may pay in equal or unequal shares, taking into account the present and prospective needs of those persons.

6.2 **Distribution on Termination.** When there is no living child of mine under age 25, the trustee shall terminate the Children's Single Fund Trust by allocating it in shares of equal value for my then-living children, provided that (1) if a child of mine is not then living but any descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the deceased child, if living, *per stirpes* to the child's then-living descendants, and (2) any allocation for a living child of mine shall be subject to the Child's Separate Trust provisions.

COMMENT

Article 6 deals with the "basket" trust for children if any child is under age 25. Paragraph 6.1 allows the trustee to use income and principal for a child's health, maintenance in reasonable comfort, or education. Distribution by a trustee to one child will not be considered an advancement against that child's share when the basket trust terminates. Holding the property in a basket trust allows the grantor's wealth to be pooled to meet certain priority risks, such as providing funds for a child's college and graduate school education in order to provide the younger children with similar opportunities to those already provided to the older children during the grantor's life.

When the youngest child reaches age 25, the basket trust terminates pursuant to Paragraph 6.2 and funds are distributed in equal shares to the then living children. The age at which the Children's Single Fund Trust is distributed, which is age 25 in this document, can be increased or decreased depending on the circumstances and the grantor's desires. If a child is then deceased, the share that would have been distributed to that child had he or she been living is distributed to his or her then living children (the grandchildren of the grantor) in equal shares. This is referred to as a per stirpes distribution. The definition of "per stirpes" is provided at Paragraph 14.10.

It is often useful to explain a per stirpes distribution to the client. The following example may be helpful. Assume the grantor had two children, A and B, and that at the

termination of the Family Trust both are deceased. A had one child, and B had two children, all of whom are living. The direction to distribute the then remaining trust property to living descendants, per stirpes, means that the funds will be distributed (1) one-half to the living child of A and (2) one-quarter to each living child of B. A per capita distribution, on the other hand, would provide for each grandchild to receive a one-third share.

Article 7
Child's Separate Trusts

Any trust property allocated for a child of mine subject to the Child's Separate Trust provisions shall be added to or used to fund the principal of a Child's Separate Trust for the child. The trustee shall administer each Child's Separate Trust as follows:

7.1 **Payment of Income.** The trustee shall pay all the income to the child.

7.2 **Discretionary Payment of Principal.** The trustee may pay to the child as much of the principal as the trustee considers necessary for the health, maintenance in reasonable comfort or education of the child.

7.3 **Right of Withdrawal.** After the child has attained age 30, the trustee shall distribute as much of the principal of the Child's Separate Trust to the child as the child at any time or times requests by an instrument signed by the child and delivered to the trustee during the child's life, not exceeding, in the aggregate, half in value before the child has attained age 35. When determining the amount subject to withdrawal, the value of the principal shall be determined when the child first exercises the right to withdraw, and shall be increased by the value of any subsequent additions as of the time of addition. A child may exercise a withdrawal right only voluntarily, and the trustee shall disregard any involuntary attempt to exercise the right.

7.4 **Payment of Child's Separate Trust Death Taxes.** On the death of the child, unless the child directs otherwise by will or trust specifically referring to this instrument, the trustee shall pay the Child's Separate Trust death taxes from the principal of the Child's Trust not withdrawn, provided that if the trust has an inclusion ratio of zero for purposes of the federal generation-skipping tax, then the trustee shall pay the Child's Separate Trust death taxes only from the principal of the Child's Separate Trust subject to withdrawal but not withdrawn.

7.5 **Power of Appointment at Death.** On the death of the child, the trustee shall distribute the Child's Separate Trust not withdrawn and not required for payment of the Child's Separate Trust death taxes to any one or more persons, charitable organizations, and the child's estate, as the child appoints by will, except that if any portion of the Child's Separate Trust was not subject to withdrawal prior to the death of the child and the trust has an inclusion ratio of zero for purposes of the federal generation-skipping tax, then that portion may be appointed only to any one or more of my descendants and their spouses (excluding the child but including the child's spouse).

7.6 **Distribution on Termination.** On the death of the child, the trustee shall dispose of the Child's Separate Trust not withdrawn and not effectively appointed as follows:

(a) **Any Descendant Living.** If the child has any descendant then living, the trustee shall distribute the trust property *per stirpes* to the child's then-living descendants; or

(b) **No Descendant Living.** If the child has no descendant then living but I have any descendant then living, the trustee shall allocate the trust property in shares of equal value for my then-living children, provided that (1) if a child of mine is not then living but any descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the deceased child, if living, *per stirpes* to the child's then-living descendants, and (2) any allocation for a living child of mine shall be subject to the Child's Separate Trust provisions.

COMMENT

Article 7 provides for a separate trust for each child once the Children's Single Fund Trust terminates, i.e., when no child is under the age of 25 years. Clients often want property held for children in separate trusts until they reach a prescribed age over age 25, especially when substantial amounts of money are to be distributed to the children. If the client desires all the property to be distributed outright to the children when the youngest reaches 25, then this provision need not be included. If property is to be retained in trust, the client is free to design the trusts in any way. The trusts in this form are single-beneficiary trusts that will vest the property in the child for estate tax purposes at age 35.

Paragraph 7.1 directs the trustee to distribute all income to the beneficiary. "Income," for these purposes, means accounting income. There is no discretion in the trustee to accumulate income. Mandatory income distributions simplify income tax planning and tax return preparation.

Paragraph 7.2 allows for the discretionary distribution of principal as the trustee determines pursuant to a narrow distribution standard relating to the child's health, maintenance in reasonable comfort, or education. This standard can be narrowed or broadened depending on the situation. A broader standard might read as follows: "The trustee shall make payment as desirable for the health, maintenance in reasonable comfort, education, welfare, or best interests of the child."

Staggered withdrawal rights are provided in Paragraph 7.3, with fractions of the trust property distributed at defined ages. The language is actually worded as a power of appointment rather than a right of withdrawal. The ages at which withdrawals can be made may be increased, decreased, or staggered over a longer period of time.

It is likely that the child's trust will terminate prior to the child's death as a result of the child's exercise of the child's right to withdraw property at certain ages. If the child does not terminate his or her trust during life, Paragraph 7.5 allows a child to appoint the property at the child's death, assuming the trust has not previously terminated, to any person or organization, including the child's estate, selected by the child, except with respect to any portion of the trust not subject to withdrawal if the trust has an inclusion ratio of zero. This exception may protect a portion of the trust from estate tax if the child dies before attaining age 35. If GST exemption is allocated to the trust and the inclusion ratio is more than zero but less than one, the trustee could divide the trust into two separate trusts for purposes of ensuring that one of the sub-trusts will have a zero inclusion ratio. See Paragraph 12.11 and Code Section 2642(a)(3). In a non-GST plan the child's unified credit and charitable and marital deductions, if applicable, are likely to prevent any estate tax from being paid.

Paragraph 7.6 provides that if the child dies prior to exercising the child's withdrawal rights and the child does not exercise the power of appointment at death, the remaining trust property is distributed to the child's then living descendants, per stirpes. If the child has no descendants, the property is distributed to the grantor's then living descendants, per stirpes, which will include the child's siblings. Shares that are distributable to a beneficiary who has another Child's Separate Trust in place under the document will be distributed to the beneficiary's trust in lieu of being distributed outright to that beneficiary. The use of the phrase "subject to the Child's Separate Trust withholding provisions" is used throughout the document, including this provision, to accomplish the above result.

Article 8
Distribution Provisions

8.1 **Contingent Gifts.** On the death of the last to die of all beneficiaries of any trust (the "termination date"), any of the trust not otherwise distributable shall be distributed half to my heirs and half to my spouse's heirs. Heirs and their respective shares shall be determined under the laws of descent and distribution of Illinois at my death for property located in Illinois as if my spouse and I had each died on the termination date unmarried and domiciled in Illinois.

8.2 **Facility of Payment.** The trustee may pay trust property (other than distributions on termination or a distribution pursuant to a power of appointment) to a beneficiary who is incapacitated in any of the following ways: (a) by paying to the beneficiary directly; (b) by paying the beneficiary's bills and other obligations directly, (c) by reimbursing an adult relative or friend of the beneficiary for expenditures on behalf of the beneficiary that the trustee could have paid directly; (d) by paying to a custodian for the beneficiary under a Uniform Transfers or Gifts to Minors Act; and (e) by paying to the legally appointed guardian of the beneficiary. The trustee may pay trust property directly to a beneficiary who is not incapacitated or on the direction of the beneficiary in any of the ways listed in (b)-(d) above. The provisions of this paragraph shall not apply to the extent that the trustee's action would disqualify a gift from the federal estate tax marital deduction.

8.3 **Withholding Provision.** Except as otherwise specifically provided in this instrument or by the exercise of a power of appointment, any property that is not otherwise directed to be held in trust and is to be distributed to a beneficiary who is not my spouse or a child of mine and is under age 25 at the time of distribution, or is then incapacitated, shall immediately vest in the beneficiary, but the trustee shall retain the property as a separate trust for the beneficiary on the following terms. The trustee may pay to the beneficiary as much of the income and principal as the trustee considers advisable for the beneficiary's health, maintenance in reasonable comfort, education, or best interests. The trustee shall distribute the remaining trust property to the beneficiary when the beneficiary attains age 25 or to the beneficiary's estate if the beneficiary dies prior to receiving the assets. If at the time the trust is created or during the administration of the trust the beneficiary is under age 21, the trustee may terminate the trust and distribute the property to a custodian for the beneficiary under a Uniform Transfers or Gifts to Minors Act.

COMMENT

Several general distribution provisions are grouped into one Article in order to provide greater organization (and fewer articles) in the document.

Paragraph 8.1:

Paragraph 8.1 provides for ultimate distribution if all of the intended beneficiaries die before the complete termination of the trusts. The default provision selected for this document splits the assets between the families of the two spouses. The clause prevents a lapse of interests, and a possible probate proceeding, if the spouses and all of their descendants perish before the trusts are completely distributed.

Paragraphs 8.2 and 8.3:

Paragraphs 8.2 and 8.3 are grouped with the contingent distribution provision because they also concern general payment provisions that are not peculiar to a given trust. Both provisions are standard for any well drafted trust. Paragraph 8.2 allows a beneficiary who is not disabled to direct the trustee to pay bills directly to third parties. Note that the trustee will not have the facility of payment power if it would jeopardize the marital deduction.

Article 9
Trustee Succession

9.1 **Reserved Powers.** During my life I reserve the power, by writing signed by me and delivered to the trustee: (a) to remove any trustee; (b) to designate additional or successor trustees, who may act consecutively or concurrently, in any stated combination and on any stated contingency; and (c) to amend or revoke any designation. An additional or successor trustee may be a person or a qualified corporation.

9.2 **Successor Trustee.** When I cease to act as trustee, if no trustee is otherwise acting or designated to act pursuant to the preceding paragraph, my spouse shall be the successor trustee.

9.3 **Resignation.** A trustee may resign at any time by signed notice to the co-trustees, if any, and to the income beneficiaries.

9.4 **Individual Trustee Succession.** At any time after my death all then-acting trustees (unless limited by their designation as trustees) unanimously, by writing signed by them and filed with the trust records, (a) may designate one or more individuals or qualified corporations to act with or to succeed the trustee consecutively or concurrently, in any stated combination and on any stated contingency, and (b) may amend or revoke a prior designation before the designated trustee begins to act. Acceptance of the designation shall be made by a written instrument signed by the accepting trustee and filed with the trust records. To the extent that a later designation conflicts with a prior designation, the later designation shall control.

9.5 **Default Trustee.** If at any time no trustee is otherwise acting and no designated trustee is able and willing to act, then the first of the following who is able and willing to act shall be trustee:

(a)[FIRST SUCCESSOR TRUSTEE];

(b) [SECOND SUCCESSOR TRUSTEE];

(c) [THIRD SUCCESSOR TRUSTEE];

(d) Any Independent Trustee appointed in an instrument signed by a majority of the income beneficiaries.

9.6 **Corporate Trustee Substitution.** A corporate trustee may be removed at any time by an instrument signed by a majority of the income beneficiaries but only if, on or before the effective date of removal, a qualified corporation has been appointed corporate trustee in the same manner.

9.7 **Special Trustees.** If the trustee (the "principal trustee") is unable or unwilling to act as trustee as to any property, such person or qualified corporation as the principal trustee shall designate by signed writing shall act as special trustee as to that property. Any special trustee may resign at any time by written notice to the principal trustee. The special trustee shall have the powers granted to the principal trustee under this instrument, to be exercised with the approval of the principal trustee. Net income and any proceeds of sale shall be paid to the principal trustee, to be administered under this instrument. The principal trustee may remove and replace the special trustee at any time.

9.8 **Co-Trustees.** The following provisions shall apply whenever there is more than one trustee acting:

(a) **Control.** Except as otherwise provided, the "trustee" means all trustees collectively, and a majority of the trustees qualified to participate in an action or decision of the trustees shall control. A co-trustee shall be presumed to have approved a proposed act or a proposal to refrain from acting if the co-trustee fails to indicate its disapproval within 15 days after having received a written notice of the proposed action or inaction. Any trustee who is not qualified to participate in or dissents from any proposal shall not be liable therefor.

(b) **Delegation to Co-trustee.** Any trustee may delegate any or all of that trustee's powers and duties to a co-trustee, except that no trustee shall be permitted to delegate any discretion with respect to the distribution of income or principal to a beneficiary. Any delegation may be for a definite or indefinite period and may be revoked by the delegating trustee. Any delegation or revocation shall be in writing, signed by the delegating trustee, and delivered to the co-trustee to whom the delegation is made. Any person or institution may rely on the written certification of a co-trustee that the co-trustee has the power to act without concurrence of any other trustee, provided, however, that the co-trustee shall attach to the written certification a copy of the writing by which the powers and duties have been delegated.

(c) **Corporate Co-Trustee; Custody of Assets.** Any corporate trustee shall be the custodian of the trust property and of the books and records of the trust. Any corporate trustee may perform all acts necessary for the acquisition and transfer of personal property and money, including the signing and endorsement of checks, receipts, stock certificates and other instruments, and no person need inquire into the propriety of any such act.

COMMENT

Article 9 designates successor trustees. Successor trustees can be a very complicated aspect of an estate plan. These forms have attempted to minimize the amount of drafting time spent on this provision. Given the likely duration of the trusts contained in the instrument, the successor trustee provisions are extremely important.

Paragraph 9.1:

The original trustee is the grantor of the trust. See the establishment clause at the beginning of the form. The grantor can name, in a document separate from the trust, a successor or co-trustee under Paragraph 9.1. If the grantor cannot act as trustee and no successor has been named by the grantor, then the successor trustees named in the document will act.

The determination of whether the grantor can continue to act as trustee is made in Paragraph 2.2. The standard is "incapacity," which is defined to mean an inability to give prompt and intelligent consideration to financial affairs. The grantor's physician and spouse make this determination. The client is free to choose any method of determining incapacity — for example, the decision could be made by an adult child or a majority in number of adult children.

Paragraphs 9.2 and 9.5:

If the grantor ceases to act as trustee and no effective designation of a successor has been made by the grantor under Paragraph 9.1, the successor trustee designated in Paragraph 9.2 or Paragraph 9.5 will act. The successor trustees are designated in the order in which they will act. If one cannot act, the next one succeeds. The successors are identified in list fashion to eliminate drafting time. However, the list of Paragraph 9.5 is subject to the right of all acting trustees to designate their own successors in Paragraph 9.4. For example, the spouse is the first named successor trustee under Paragraph 9.2. Under Paragraph 9.5, if neither the spouse nor the spouse's designee (if any) can act as trustee, then provision is made for three named trustees, followed by an Independent Trustee to be named by the income beneficiaries. Section 704(c) of the UTC establishes a different priority: A vacancy that is required to be filled for a non-charitable trust must be filled first by the person designated in the instrument as the successor trustee, next by a person appointed by unanimous agreement of the qualified beneficiaries, and lastly by a person appointed by the court.

Paragraph 9.3:

Paragraph 9.3 provides a mechanism for resignation, which requires notice to be given to the income beneficiaries and co-trustees, if there are any. There is no time element for the notice. Section 705(a)(1) of the UTC provides that a trustee may resign on at least 30 days' notice to the "qualified beneficiaries," the grantor, if living, and all of the co-trustees.

Paragraph 9.4:

Paragraph 9.4 allows the trustees, acting unanimously, to designate co-trustees or successor trustees. A successor trustee or co-trustee named by the acting trustees will preempt any successor designated in Paragraph 9.5. This provision allows considerable flexibility in qualifying successor trustees but may not be desirable if the grantor wants assurance that a certain trustee will act.

Paragraph 9.6:

Paragraph 9.6 allows a beneficiary to remove any corporate trustee provided the beneficiary appoints a successor corporate trustee that is not a related or subordinate party. See Paragraph 14.11 defining "qualified corporation." This is intended to give a beneficiary of a trust control over which corporate trustee will act without causing estate tax problems. See Rev.Rul. 95-58, 1995-2 Cum.Bull. 191.

There is no general removal right that a beneficiary can exercise under the UTC. Section 706 allows a beneficiary, the grantor or a co-trustee to ask a court to remove a trustee. While a trust is revocable the rights of the beneficiaries, including the right to petition a court to remove a trustee, are subordinate to the grantor. See Section 603(a) of the UTC.

Paragraph 9.7:

Paragraph 9.7 allows the appointment of special trustees to act in situations in which a trustee is unable or unwilling to act. For example, a trustee may not be authorized to act with regard to real estate in a foreign jurisdiction. The trustee can appoint a special trustee to act in those situations. The special trustee is entitled to compensation.

Paragraph 9.8:

Paragraph 9.8 addresses relations between co-trustees. Because a sole trustee has the right to appoint a co-trustee under Paragraph 9.4, every trust may have co-trustees.

Paragraph 9.8(a) provides that if there are three or more trustees acting, decisions are made by a majority of the trustees. This provides a more workable arrangement than requiring a unanimous decision. Section 703(a) of the UTC also permits co-trustees who are unable to reach a unanimous decision to act by majority vote. If two trustees will act together under the trust, the grantor may wish to provide which trustee shall control in the event of a deadlock. This form allows a trustee who wishes to initiate action to do so if the co-trustee is unresponsive. A trustee who dissents from any action will not be liable.

Section 703(c) of the UTC requires a co-trustee to participate in the performance of a trustee's function, except if the person is unavailable because of absence, illness, disqualification under other law (such as under ERISA or securities laws), other temporary incapacity, or if the trustee has properly delegated the function to a co-trustee. If the person is unavailable to perform the duties on account of one of the foregoing reasons, and prompt action is necessary to achieve the purposes of the trust or to avoid injury to the trust property, the remaining trustees can act by majority vote. See Section 703(d).

See also Section 703(f), which states that a trustee who does not join in the action of another trustee is not liable for the action. Despite Section 703(f), the UTC requires a trustee to exercise reasonable care to prevent a co-trustee from committing a serious breach of trust, and to exercise reasonable care to compel a co-trustee to redress a serious breach of trust. Section 703(g).

Paragraph 9.8(b) recognizes that co-trustees may wish to delegate to one another certain powers and duties. For example, one trustee may wish to be less active in the trust administration, or a trustee who will be traveling may wish to delegate powers and duties to the other trustee. This paragraph is intended to allow that delegation, but not with respect to discretionary distributions. A copy of the delegation can be provided to third parties who question whether one trustee's actions are sufficient.

Section 703(c) of the UTC does not permit a trustee to delegate the performance of any function the grantor reasonably expected the trustees to perform jointly. The extent

to which a co-trustee may, or may not, delegate functions to another trustee may remain unclear if the grantor did not leave explicit instructions.

Article 10
Trustee Actions

10.1 **Exclusion of Interested Trustee.** Notwithstanding any other provision, an individual trustee other than me: (a) shall have no incident of ownership or power or discretion with respect to any policy of insurance on the trustee's life; (b) shall have no discretionary power to allocate or distribute assets to the extent that the power would discharge the trustee's legal obligation to support any beneficiary; (c) shall, if the trustee has a beneficial interest in a trust, have no discretionary power to allocate or distribute assets of that trust, directly or indirectly, to or for any beneficiary (including the trustee), unless necessary for the beneficiary's health, maintenance in reasonable comfort, or education (to the extent the trustee was otherwise granted those discretionary powers); and (d) shall have no other power or discretion that would be deemed a general power of appointment under Code Section 2041 unless the trustee has the power in other than a fiduciary capacity.

10.2 **Accountings***.* On written request, the trustee shall send a written annual account of all trust receipts, disbursements, and transactions and a statement of the property comprising the trust to each income beneficiary and, at the option of the trustee, to any one or more of the future beneficiaries of the trust. A future beneficiary of a trust is a person to whom the assets of the trust would be distributed or distributable if the trust then terminated. Unless court proceedings on the account are commenced within 6 months after the account is sent, the account shall bind and be deemed approved by all of the following beneficiaries who have not delivered notice of objections to the account to the trustee within 3 months after the account is sent, and the trustee shall be deemed released by all those beneficiaries from liability for all matters covered by the account as though the account was approved by a court of competent jurisdiction: (a) each income beneficiary to whom the account was sent, that income beneficiary's heirs and assigns and all persons who will succeed to that income beneficiary's income interest upon the termination of the income beneficiary's interest; and (b) if the account was sent to a future beneficiary of the trust then (1) that future beneficiary; (2) that future beneficiary's heirs and assigns; and (3) any person whose interest in the trust is dependent on surviving that future beneficiary, or whose interest in the trust will follow the interest of the future beneficiary.

10.3 Trustee's Right to Account Settlement Before Distribution*.* Before distribution of any trust principal, the trustee shall have the right to require settlement of any open accounts of the trust from which the distribution is being made, either by the written approval and release of all beneficiaries having an interest in the distribution or, if the releases cannot be obtained, by court settlement of the open accounts. All the trustee's reasonable fees and expenses (including attorneys' fees) attributable to approval of the trustee's accounts shall be paid from the trust.

10.4 **Acceptance of Predecessor's Accounts.** On the signed direction of a majority of the income beneficiaries, the trustee shall accept without examination the accounts rendered and property delivered by or for a predecessor trustee or my executor. That acceptance shall fully discharge the predecessor trustee or my executor and shall bind all beneficiaries.

10.5 **Notice.** If a beneficiary is incapacitated, the trustee shall give any notice or accounting to any of the following: (a) the personal representative of the beneficiary's estate; (b) the beneficiary's agent under a power of attorney; (c) a custodian for the beneficiary under a Uniform Transfers to Minors Act; (d) a parent of the beneficiary; (e) any other person who serves in any other fiduciary relationship to the beneficiary, or (f) the person whom the trustee believes has demonstrated a substantial ongoing concern for the financial or personal interests of the beneficiary. That person may sign any instrument for the beneficiary and the trustee may rely on that signature.

10.6 **Compensation.** The trustee shall be entitled to reimbursement for expenses and to reasonable compensation.

10.7 **Determinations by Trustee.** The trustee's reasonable determination of any question of fact shall bind all persons.

10.8 **Third-Party Dealings.** The trustee's certification that the trustee is acting according to this instrument shall protect anyone dealing with the trustee. No one need see to the application of money paid or property delivered to the trustee.

10.9 **Exoneration of Trustee and Advisors.** Any man or woman who is acting as a trustee, including a co-trustee to whom powers have been delegated, and any man or woman or committee of men or women with respect to investments and special assets, if any, who act in good faith, shall not be liable for any act or omission. No trustee shall be liable for any act or omission of another trustee.

10.10 **Bond.** No trustee need give bond or security to, qualify before or account to any court.

10.11 **Powers of Successor Trustee.** Unless expressly limited, each successor trustee shall have all the titles, powers, duties, discretions and immunities of the original trustee.

COMMENT

Article 10 concerns the actions of the trustee. The provisions are typical but broad enough to deal with most situations. Of course, the client could expand or narrow, or even omit, any of the paragraphs.

Paragraph 10.1 is a savings provision intended to make sure that no trustee who is also a beneficiary can possess or exercise any power that would result in the property being included in the trustee's gross estate. A beneficiary/trustee is limited to ascertainable standards in making distributions to himself or herself, is prohibited from distributing trust property to discharge legal obligations, and cannot possess incidents of ownership for any insurance policies on his or her life held in the trust.

The UTC also has a savings provision. Section 814(b) provides that unless the terms of the trust expressly indicate otherwise, a trustee/beneficiary's power to make discretionary payments will be limited to an ascertainable standard, and the trustee may not use funds to discharge a legal obligation of support.

Paragraph 10.2 concerns accountings. Accountings are required under the trust only on written request by the beneficiaries. To protect the trustee, the account is deemed to be binding on all beneficiaries within three months after the account is sent unless court proceedings are initiated by the beneficiaries. This provision is quite different from the requirements of the UTC.

Section 103(3) of the UTC defines a "beneficiary" as someone who has a present or future interest in a trust, whether vested or contingent, or who holds a power of appointment in a capacity other than trustee. Section 103(13) defines a "qualified beneficiary" as a person who, on the date that the qualification is determined, (A) is a distributee or permissible distribute of trust income or principal, (B) would be a distribute or permissible distribute of trust income or principal if the interests of the persons identified in A terminated on that date without causing the trust to terminate; or (C) would be a distribute or permissible distribute of trust income or principal if the trust terminated on that date. In short, a "beneficiary" is anyone who has a present or future interest in the trust, no matter how remote, while a "qualified beneficiary" is a person who may receive distributions currently or is the "next in line."

Section 813 of the UTC requires the trustee to provide certain information to the beneficiaries of the trust. Section 813(a) requires the trustee to keep the qualified beneficiaries reasonably informed of the administration of the trust and to provide a prompt response (unless the unreasonable under the circumstances) to any beneficiary's request for information. Section 813(b) imposes separate requirements for:

(1) providing a copy of the trust to any beneficiary who requests it;

(2) notifying the qualified beneficiaries of the trustee's name, address and telephone number within 60 days after accepting the trusteeship;

(3) notifying the qualified beneficiaries of a trust's existence, the identity of the grantor, the right to obtain a copy of the trust, and the right to demand information under Section 813(c) below, within 60 days after the date the trustee acquires knowledge of the creation of an irrevocable trust, or after the date that a formerly revocable trust became irrevocable;

(4) notify the qualified beneficiaries in advance of any change in the method or rate of the trustee's compensation.

Under Section 813(c) the trustee must send an annual report of trust property, liabilities, receipts and disbursements to the distributees or permissible distributees of income and principal. In addition, the trustee must send the same information to any beneficiary – no matter how remote the interest – who requests it.

The trust can override the requirements of Section 813(c), but cannot override the requirements of Section 813(b)(2) and (3) for qualified beneficiaries who have attained age 25. Nor can the grantor override the trustee's requirement under Section 813(a) to promptly respond to a beneficiary's request for information related to the administration of the trust. See Sections 105(b)(8),(9) of the UTC. The provisions of Section 105(b)(8) and (9) of the UTC have generated much controversy. The latest version of the model Code places these provisions in brackets to indicate that a state may not be likely to enact them exactly as written – and may not enact them at all.

Paragraph 10.3 is also intended to provide protection to the trustee. It allows the trustee to require the beneficiaries to approve (and release the trustee from liability for) the trustee's accounts prior to distribution of any principal, including approving the trustee's fees and expenses. In contrast, Section 817(a) of the UTC provides that on termination or partial termination of a trust, the trustee may send the beneficiaries a proposal for distribution. The right of the beneficiaries to object to the proposed distribution terminates if the beneficiary fails to notify the trustee of an objection within 30 says after the proposal is sent. The beneficiary's right to object will terminate, however, only if the proposal informed the beneficiary of the right to object and the time allowed for objection. A termination of a beneficiary's right to object to a distribution does not constitute a release of liability for the trustee's actions.

Paragraph 10.4 continues the protection of the trustee, allowing a successor trustee to accept accounts rendered by a prior trustee without liability, provided the income beneficiaries consent.

Paragraph 10.5 identifies the persons to receive notice on behalf of beneficiaries under legal disabilities, including minors and other disabled beneficiaries. The identity and priority of persons who can act differs from Section 303 of the UTC, especially by allowing the trustee to choose a person whom the trustee believes has demonstrated an ongoing concern for the beneficiary to receive notice and act.

Paragraph 10.6 allows the trustee to charge reasonable compensation and to be reimbursed for expenses. Section 708(a) of the UTC states that if the terms of a trust do not specify the trustee's compensation, a trustee is entitled to reasonable compensation under the circumstances. Section 709 of the UTC permits the trustee to claim reimbursement for expenses properly incurred in the administration of the trust, and for expenses not properly incurred but only to the extent necessary to prevent unjust enrichment of the trust.

Paragraph 10.7 is further protection to the trustee. It evidences the grantor's intention that the trustee's reasonable determination of any question of fact shall be binding on all persons. This theme is followed in Paragraph 10.9 (discussed below), exonerating any individual trustee who acts in good faith.

Paragraph 10.8 follows the recognized practice that third parties making payments to the trustee need not see how those funds are actually used. Section 1012(c) of the UTC provides that a person who in good faith delivers assets to a trustee need not ensure their proper allocation.

Under Paragraph 10.8, the trustee may provide a "certification" to third parties that the trustee is acting under the document. The certification absolves the third party from the responsibility of reviewing trust documents. Section 1012(b) of the UTC provides that a beneficiary who in good faith deals with the trustee is not required to inquire into the extent of the trustee's powers or the propriety of their exercise. Under the UTC, a beneficiary who wishes to rely on a certification from the trustee may request one under Section 1013.

Paragraph 10.9 exonerates individual trustees and advisors who act in good faith, and provides that no trustee shall be liable for the act or omission of another trustee. Section 1008 of the UTC provides that a term of a trust relieving a trustee of liability for breach of

trust is unenforceable to the extent that it (1) relieves the trustee of liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries, or (2) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship of the settlor.

Paragraph 10.10 excuses the trustee from giving any bond or accounting to any court. This provision would not prevent a beneficiary from seeking a judicial accounting or requesting a court to require the trustee to give bond. Section 702 of the UTC likewise does not require bond of a trustee unless the terms of the trust require it or a court orders it for the protection of the beneficiaries. Under the UTC the trust can never override the power of a court to require, dispense with, or modify or terminate a bond. See Section 105(b)(6).

Paragraph 10.11 gives a successor trustee all the powers of the prior trustee.

Article 11
Trustee Powers

In addition to all powers granted by law, the trustee shall have the following powers, to be exercised in a fiduciary capacity:

11.1 **Retention.** To retain any property transferred to the trustee, regardless of diversification and regardless of whether the property would be considered a proper trust investment;

11.2 **Sale.** To sell at public or private sale, contract to sell, grant options to buy, transfer, exchange or partition any real or personal property of the trust for any price and terms the trustee considers advisable;

11.3 **Real and Tangible Personal Property.** To lease and sublease and grant options to lease, although the terms may commence in the future or extend beyond the termination of any trust; to purchase, operate, maintain, improve, rehabilitate, alter, demolish, abandon, release or dedicate any real or tangible personal property; and to develop or subdivide real property, grant easements, and take any other action with respect to real or tangible personal property that an individual owner could take;

11.4 **Borrowing.** To borrow money from any lender (including the trustee individually), extend or renew any existing indebtedness, and mortgage or pledge any property in the trust; and also to open accounts, margin or otherwise, with brokerage firms, banks or others, and to invest the trust property in, and to conduct, maintain and operate, these accounts for the purchase, sale and exchange of stocks, bonds and other securities, and to borrow money, obtain guarantees, and engage in all other activities necessary or incidental to conducting, maintaining and operating these accounts;

11.5 **Investing.** To invest in common or preferred stocks, bonds, notes, options, common trust funds, mutual funds, shares of any investment company or trust or other securities, life insurance, partnership interests, general or limited, limited liability company interests, joint ventures, real estate or other property of any kind, regardless of diversification and regardless of whether the property is considered a proper trust investment;

11.6 **Joint Investments; Distribution; Determination of Value.** To make joint investments for two or more trusts held by the same trustee; to distribute property in cash or in kind or partly in each; and to allocate or distribute undivided interests, different property or disproportionate interests to the beneficiaries, and to determine the value of any property so allocated or distributed; but the trustee need not make any adjustment to compensate for a disproportionate allocation of unrealized gain for federal income tax purposes, and no action taken by the trustee pursuant to this paragraph shall be subject to question by any beneficiary;

11.7 **Rights as to Securities.** To have all the rights, powers, and privileges of an owner of the securities held in trust, including, the powers to vote, give proxies, and pay assessments and to participate in voting trusts, pooling agreements, foreclosures, reorganizations, consolidations, mergers, and liquidations and, incident to the trust's participation, to exercise or sell stock subscription or conversion rights;

11.8 **Conservation of Assets.** To take any action that an individual owner of an asset could take to conserve or realize the value of the asset and with respect to any foreclosure, reorganization or other change with respect to the asset;

11.9 **Delegation.** To employ agents, attorneys, accountants, investment advisors and proxies of all types (including any firm in which a trustee or his or her spouse or any relative of mine or his or her spouse is a partner, associate or employee or is otherwise affiliated) and to delegate to them any powers the trustee considers advisable;

11.10 **Payment of Expenses and Taxes.** To pay all expenses incurred in the administration of the trust and to pay all taxes imposed on the trust;

11.11 **Determination of Principal and Income.** To determine in cases not covered by statute the allocation of receipts and disbursements between income and principal, except that (a) if the trust is beneficiary or owner of an individual account in any employee benefit plan or individual retirement plan, income earned in the account after death of the participant, shall be income of the trust, and if the trustee is required to pay all trust income to a beneficiary, the trustee shall collect and pay the income of the account to the beneficiary at least quarterly (and to the extent that all income cannot be collected from the account, the deficiency shall be paid from the principal of the trust); and (b) reasonable reserves for depreciation, depletion, and obsolescence may be established out of income and credited to principal only to the extent that the trustee determines that readily marketable assets in the principal of the trust will be insufficient for any renovation, major repair, improvement or replacement of trust property that the trustee considers advisable;

11.12 **Dealings with Fiduciaries.** To deal with, purchase assets from or make loans to the fiduciary of any trust made by me or a trust or estate in which any beneficiary under this trust has an interest, even though a trustee under this instrument is the fiduciary, and to retain any assets or loans so acquired, regardless of diversification and regardless of whether the property would be considered a proper trust investment; to deal with a corporate trustee under this instrument individually or a parent or affiliate company; and to deal with the fiduciary of any other estate, trust or custodial account even though the fiduciary is a trustee under this instrument;

11.13 **Compromising Claims.** To litigate, compromise, settle or abandon any claim or demand in favor of or against the trust;

11.14 **Nominee Arrangements.** To hold any asset in the name of a nominee, in bearer form or otherwise, without disclosure of any fiduciary relationship;

11.15 **Elections Under Retirement Plans.** To elect, pursuant to the terms of any employee benefit plan, individual retirement plan or insurance contract, the mode of distribution of the proceeds or change the beneficial ownership, and no adjustment shall be made in the interests of the beneficiaries to compensate for the effect of the election or change;

11.16 **Loans.** To make loans to any person or entity, including any trust or estate, upon terms that the trustee considers advisable; to make any loans with or without security and subordinate the loan to other obligations of the indebted party; to retain any assets or loans so acquired, regardless of diversification and regardless of whether the property would be considered a proper trust investment.

11.17 **Liability Insurance.** To purchase liability and casualty insurance of any kind for the protection of the trust property, including comprehensive liability insurance;

11.18 **Accepting Additional Property.** To accept additional property from any source and administer it as a part of the trust and, if the addition is made by a will, to accept the statement of the personal representative of the estate of the transferor that the property delivered to the trustee constitutes all of the property to which the trustee is entitled without any duty to inquire into the representative's administration or accounting;

11.19 **Environmental Matters.** To inspect and monitor businesses and real property (whether held directly or through a partnership, corporation, trust or other entity) for environmental conditions or possible violations of environmental laws; to remediate environmentally damaged property or to take steps to prevent environmental damage in the future, even if no action by public or private parties is currently pending or threatened; to abandon or refuse to accept property that may have environmental damage; and to expend trust property to do the foregoing; and no action or failure to act by the trustee pursuant to this paragraph shall be subject to question by any beneficiary;

11.20 **Closely-Held Interest.** To retain any business interest, as shareholder, security holder, creditor, partner, proprietor, member or otherwise, even though it may constitute all or a large portion of a trust; to participate in the management and conduct of any business to the same extent as could an individual owner of any business; to vote the stock of any business interest and to determine all questions of policy; to execute partnership or other organizational agreements and amendments; to deposit securities in a voting trust; to participate in any incorporation, reorganization, merger, consolidation, recapitalization, liquidation or dissolution of any business or any change in its nature; to invest additional capital in any business by subscribing to or purchasing additional stock or securities of any business or by making secured, unsecured or subordinated loans to any business with trust funds; to elect or employ as directors, officers, employees or agents of any business such persons (including a trustee or a director, officer or agent of a trustee) as are necessary and at such compensation as is appropriate; to rely on the reports of certified public accountants as to the operations and financial condition of any business without independent investigation; and to sell or liquidate any interest in any business; and the trustee may retain and continue any business interest pursuant to this paragraph without liability for any loss and without application to any court;

11.21 **Stock Options.** To exercise any stock option as the trustee considers advisable, and to pledge or mortgage the trust property as collateral for any related loan;

11.22 **S Corporation Stock.** To transfer any shares of stock of an S corporation, shares of stock of a C corporation which is intended to qualify as and elect to be treated as an S corporation or any assets that are intended to be used to acquire shares of stock of an S corporation, held by or allocated to any separate trust created under this instrument (referred to in this paragraph as the "original trust"), to one or more new trusts (referred to in this paragraph as a "sub-trust") for the purpose of enabling each sub-trust to qualify as a qualified subchapter S trust ("QSST"), as defined in the Code; to make all elections and take all steps necessary for each sub-trust created under this instrument to qualify as a QSST; to hold and administer each sub-trust created under this instrument under any terms as are necessary for each sub-trust to be a QSST and, in particular, (a) to hold each sub-trust for the benefit of one person who shall then be a citizen or resident of the United States and a beneficiary of the original trust to whom the trustee could have distributed the shares of stock or other assets from the original trust, (b) to distribute all of the net income of the sub-trust to the beneficiary of the sub-trust from and after the date the sub-trust owns stock in an S corporation, (c) to distribute the principal of the sub-trust to the beneficiary of the sub-trust under the same terms as principal could have been distributed to the beneficiary from the original trust, (d) to hold the trust property of each sub-trust subject to the same testamentary power of appointment, whether limited or general, if any, that the beneficiary of the sub-trust would have held over the original trust, and (e) to allocate the then remaining trust property of the sub-trust upon the death of the beneficiary in separate shares to those persons to whom the trust property of the sub-trust would have been allocated if the assets of the sub-trust had continued to be held as assets of the original trust and the original trust terminated on the death of the beneficiary, and retain each share directed to be retained by the trustee in trust as a further sub-trust pursuant to the terms of this paragraph; provided, however, that if the Code is revised with respect to the requirements necessary for a trust to qualify as a QSST or for any other reason, so that any provision of this subparagraph prevents any separate sub-trust created under this instrument from qualifying as a QSST, the provision shall be stricken or conformed at the trustee's sole and absolute discretion so that the sub-trust will qualify;

11.23 **Farm and Forest.** To acquire any farm or forest property, and to retain farm and forest property whether acquired by the trustee or received from any source; to engage in farm and forestry operations and the production, harvesting and marketing of farm and forest products, including livestock breeding and feeding and poultry and dairy farming, either by operating directly with hired labor, by retaining farm managers or management agencies, by renting on shares or for cash, by entering into logging contracts or selling standing timber or in any other manner; to enter into farm programs; to purchase or rent farm and forest machinery and equipment, livestock, poultry, seed and feed; to improve farm and forest property and to repair, improve and construct farm buildings, fences and drainage facilities; to develop or lease or otherwise dispose of mineral, oil and gas property and rights; to borrow money for any of these purposes; and in general to do all things customary or desirable in the business of farming and forest operations; and the trustee may retain or acquire any farm or forest property pursuant to this paragraph without liability for any loss and without application to any court;

11.24 **Qualified Conservation Easements.** To create, on land meeting the requirements of Code Section 2031(c)(8)(A), a qualified conservation easement, as defined in Code Section 2031(c)(8)(B), with or without the consent of any beneficiary, and to make the election provided in Code Section 2031(c)(6);and

11.25 **Ability To Take Other Actions.** To do all other acts to accomplish the proper management, investment, and distribution of the trust.

COMMENT

Article 11 describes the powers of the trustees. The language is straightforward and should be understandable to the client. The powers also have been expanded to include several uncommon powers; see, e.g., Paragraphs 11.19 - 11.24.

Under Section 815(a) of the UTC, a trustee, except as limited by the provisions of the trust, may exercise all powers over the trust property which an unmarried competent owner has over individually-owned property. The UTC sets forth specific powers in Section 816, which are similar to the powers set forth in the form at Paragraphs 11.1-11.18.

Paragraph 11.1 allows the trustee to retain any property regardless of lack of diversification or consistency with the prudent investor rule that applies under the laws of many states. But see the comments below with respect to Paragraph 11.5.

Paragraph 11.2 allows for the sale of property as the trustee determines appropriate.

Paragraph 11.3 discusses the trustee's powers with regard to real and tangible personal property.

Paragraph 11.4 allows the trustee to borrow from anybody, including a beneficiary, as well as to mortgage or pledge trust property.

Paragraph 11.5 allows the trustee to invest in any asset the trustee deems appropriate, regardless of diversification and regardless of whether the trust investment would be considered a proper trust investment. The authority to purchase an investment that is not ordinarily suitable for a trust investment does not insulate the trustee from liability for bad decisions. Waiver of the duty of diversification and the duty to invest prudently generally means that a trustee's decision not to diversify or to purchase an asset not traditionally suitable as a trust investment is not per se a breach of trust, but the judgment of the trustee will always be subject to scrutiny.

Paragraph 11.6 allows several trusts to combine assets in common investments. See also Section 810(d) of the UTC, which allows the trustee to make joint investments as long as the trustee maintains records clearly indicating the respective interests. Paragraph 11.6 also allows the trustee to make distributions of property in kind rather than forcing a liquidation that requires the trustee to sell assets prior to a distribution. Distributions or sales may be made by the trustee without adjustments for tax ramifications. This paragraph is intended to abrogate any requirement of compensating adjustments.

Paragraph 11.7 gives the trustee all rights with regard to securities, including entering into voting trusts.

Paragraph 11.8 allows the trustee to litigate with regard to any asset and to settle the litigation.

Paragraph 11.9 allows the trustee to employ agents, attorneys, and other advisors to assist in the administration of the trust. The delegation to a third party under this Paragraph is different from a trustee-to-trustee delegation under Paragraph 9.9. Section 807(a) of the UTC permits a trustee to delegate duties that a prudent trustee of comparable skills could properly delegate under the circumstances, but requires the trustee to exercise reasonable care, skill and caution in selecting an agent, establishing the scope and terms of the delegation (consistent with the purposes and terms of the trust) and periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

Paragraph 11.9 also recognizes that conflicts may exist because of the individuals who are hired, and specifically waives any concern with regard to those conflicts. Section 802(b) of the UTC provides that a transaction involving the investment or management of trust property which is affected by a conflict between the trustee's fiduciary and personal interests is voidable by the beneficiary. Section 802(c) presumes that a transaction is affected by a conflict between fiduciary and personal interests if the trustee enters into it with (1) the trustee's spouse, (2) the trustee's descendants, siblings, parents or their spouses, (3) an agent or attorney of the trustee, or (4) a corporation or other person or enterprise in which the trustee, or a person that owns a significant interest in the trustee, has an interest that might affect the trustee's best judgment.

Paragraph 11.10 allows for the payment of expenses in the administration of the trust.

Paragraph 11.11 discusses the allocation of receipts and expenses as between income and principal. Although the language reflects the common procedure of allowing the trustee broad discretion to allocate receipts and expenses as between income and principal, the language also allows for the possibility that an IRA or other qualified retirement plan could be paid and allocated to the Marital Trust and still qualify for the marital deduction. This addresses, in a conservative fashion, the requirements of Rev.Rul. 2000-2, 2000-1 Cum.Bull. 305, as modified by Rul. 2006-26, 2001-C.B. 305.

Paragraph 11.12 allows the trustee to deal with others, including the trustee himself or herself, in various fiduciary capacities, even though a conflict of interest may occur. Section 802(h)(3) of the UTC contains a similar exemption from the trustee's general duty of loyalty for transactions between fiduciaries.

Paragraph 11.13 allows the trustee to deal with litigation and to settle or decide claims.

Paragraph 11.14 allows the trustee to hold assets in bearer form or otherwise, expressly recognizing the possibility of custodial arrangements and brokerage arrangements in the trust capacity.

Paragraph 11.15 allows the trustee to elect modes of distribution under retirement plans.

Paragraph 11.16 allows the trustee to loan trust property.

Paragraph 11.17 allows the trustee to purchase insurance to protect trust assets.

Paragraph 11.18 allows the trustee to accept additional property from any source, including the grantor and the grantor's estate.

Paragraph 11.19 concerns real property that may be contaminated because of strict liability statutes under federal law (such as Superfund) and various state statutes. If property does have environmental problems, then in certain situations the trust should not accept it. This paragraph allows the trustee to refuse to accept such property. Section 816(13)(C) of the UTC likewise permits a trustee to refuse to accept contaminated property. Section 816(12) allows the trustee to abandon any property if its value is insufficient to justify its collection or continued administration.

Paragraph 20 permits the trustee to hold an interest in a closely-held business. Retaining closely held businesses, especially when the businesses constitute a large portion of the trust estate, could violate the prudent investor rule under the laws of many states. Accordingly, an express provision needs to be made authorizing, allowing, or even directing the trustee to retain such property. A direction may be preferable to mere allowance, in order to lessen potential liability if the asset declines in value. Note that the direction to retain a closely held asset should be subject to a spouse's right to compel the trustee to make any marital trust property productive of a reasonable income. The management of closely held companies also presents potential conflict concerns because the trustee may also be acting as a director or officer of the company. The grantor should acknowledge the potential conflict and in most situations should waive on behalf of the trust any conflict arising from the trustee acting in dual and perhaps conflicting capacities. The trustee should also be protected from liability for actions in good faith.

Paragraph 11.21 authorizes the trustee to exercise stock options.

Paragraph 11.22 permits the trustee to create a separate trust to qualify as a QSST.

Paragraph 11.23 authorizes the trustee to invest in farm and forest property. These may include interests in working farms, and timber interests.

Paragraph 11.24 allows an exclusion from the gross estate for certain easements placed in land that are created and placed on the land after the death of the decedent, up to the time for filing the estate tax return.

Finally, Paragraph 11.25 is a catch-all provision that is intended to allow the trustee to do whatever is necessary to accomplish the purposes of the trust.

Article 12
Administrative Provisions

12.1 **Administration After My Death.** After my death, the trustee may hold the Lifetime Trust as a separate trust until all payments, allocations, and distributions from the Lifetime Trust directed by this instrument have been completed. If the Lifetime Trust is held as a separate trust under the preceding sentence, the trustee at any time may distribute income or principal to fund the succeeding interests wholly or partially, and shall (a) completely fund the succeeding interests as soon as practicable after my death and (b) distribute at least annually all the income attributable to any gift for which a federal estate tax marital deduction is allowable in my estate.

12.2 **Income Payments; Accumulation.** Mandatory income payments shall be made at least quarterly. If income is payable in the discretion of the trustee, any unpaid income in each tax year shall be added to principal at the end of that year. Unpaid income for any year shall be the amount of income unpaid after considering payments in a subsequent year that by election relate to the current year.

12.3 **Standard for Discretionary Payments.** When determining whether to make a discretionary payment to a beneficiary: (a) the trustee may consider all income and resources the trustee knows to be available to the beneficiary, the standard of living of the beneficiary and any other factors the trustee considers advisable; and (b) the trustee's authority to distribute principal pursuant to a stated standard shall include the authority to distribute all of the principal pursuant to that standard even if that distribution terminates the trust.

12.4 **Exercise of Power of Appointment.** The exercise of a power of appointment granted under this instrument may be either directly to the appointee or subject to any trusts and conditions that the holder of the power designates; and shall apply to as much of the trust as the holder of the power directs. The holder of the power may grant to any person to whom principal may be appointed further powers of appointment. A lifetime power of appointment may be exercised only by signed instrument delivered to the trustee during the lifetime of the holder of the power, specifically referring to this instrument. A testamentary power of appointment may be exercised only by a will specifically referring to this instrument. In determining whether a testamentary power of appointment has been exercised, the trustee may rely on an instrument admitted to probate in any jurisdiction as the will of the holder of the power, or may assume the power of appointment was not exercised if the trustee does not receive actual notice of the holder's will within three months after the holder's death.

12.5 **Marital Deduction Provisions.**

(a) **Discretionary Qualified Terminable Interest Property Election**. The trustee may elect, and may direct my executor to elect, to treat as qualified terminable interest property for federal estate tax purposes any fraction or all of any trust in which my spouse has a qualifying income interest for life under Code Section 2056(b)(7).

(b) **Marital Deduction Qualification.** To the extent an election is made to treat a trust as qualified terminable interest property, or to the extent a trust by its terms qualifies for the federal estate tax marital deduction without an election, I intend the trust to qualify for the federal estate tax marital deduction, and the provisions of this instrument shall be so construed. To the extent a provision of this instrument would result in such a trust not so qualifying, that provision shall be ineffective.

(c) **Unproductive Property**. Despite any provision in this instrument to the contrary, if my spouse directs in writing, the trustee of any "Marital Deduction Trust" shall convert unproductive property into property that produces a reasonable rate of income. A Marital Deduction Trust shall be any trust (1) in which my spouse has a qualifying income interest for life under Code Section 2056(b)(7), or (2) which by its terms qualifies for the federal estate tax marital deduction without an election.

(d) **Disclaimer of Marital Trust**. If my spouse survives me but disclaims any part of the Marital Trust, the disclaimed property shall be added to the Family Trust, except that my spouse shall have no power of appointment over the disclaimed property.

12.6 **No Advancements**. Unless I have directed otherwise in this instrument, no payment made to any beneficiary under this instrument shall be treated as an advancement.

12.7 **Allocation of Assets and Income**. When funding any pecuniary gifts (including any pecuniary formula gifts), the trustee may allocate or distribute assets in any manner, but the trustee shall value each asset at its fair market value on the date on which the asset is allocated or distributed. Any pecuniary gift (including any pecuniary formula gift) in trust or to my spouse shall include a pro rata share of the income of the trust property from the date of my death to the date or dates of allocation or distribution.

12.8 **Administrative Termination of Trust**.

(a) **Small Trust Termination**. The trustee may terminate any trust with a value at the time of termination less than the Minimum Trust Value. This power may not be exercised by a trustee who is a beneficiary of the trust, who is the spouse of a beneficiary of the trust or who is legally obligated to a beneficiary of the trust. The Minimum Trust Value shall be the sum of (1) $100,000 and (2) the percentage increase, if any, in the cost of living from January 1 of the year in which I executed this instrument until January 1 of the year of termination multiplied by $100,000. For this purpose, the increase in the cost of living shall be determined pursuant to the Consumer Price Index for Urban Wage Earners and Clerical Workers, U.S. City Average, All Items, as published by the Bureau of Labor Statistics of the U.S. Department of Labor. If that index ceases to be published, there shall be substituted any other index the trustee determines to reflect similar information.

(b) **Qualified Perpetual Trust; Rule Against Perpetuities**. I intend that each trust established under this instrument shall be a Qualified Perpetual Trust under Illinois law and shall not be subject to the Rule Against Perpetuities. The power of the trustee to sell, lease or mortgage assets shall be construed as enabling the trustee to sell, lease or mortgage trust property for any period beyond the Rule Against Perpetuities. If assets that would not qualify as part of a Qualified Perpetual Trust would otherwise be part of or be added to any trust established under this instrument, the trustee shall segregate those assets and administer them as a separate trust identical to the one to which the assets would have been added, except that, despite any other provision, 21 years after the death of the last to die of all of the beneficiaries living on the earliest date I could no longer change the terms of this trust, each such separate trust then held under this instrument shall be terminated and distributed.

(c) **Distribution on Termination**. Distribution under this paragraph shall be to the income beneficiaries in the proportions in which they are entitled to share the income or, if their interests are indefinite, to my spouse, if my spouse is an income beneficiary of the trust and is then living, otherwise to the income beneficiaries in equal shares.

12.9 Spendthrift. No interest under this instrument shall be assignable by any beneficiary or be subject to the claims of the beneficiary's creditors, including claims for alimony or separate maintenance. The preceding sentence shall not be construed as restricting in any way the exercise of any right of withdrawal or power of appointment or the ability of any beneficiary to release an interest.

12.10 Consolidation. The trustee may at any time or times consolidate any trust held under this instrument with any other trust if the beneficiaries of the trusts are the same and the

terms of the trusts are substantially similar. The shortest of the perpetuities periods of the trusts shall apply to the consolidated trust.

12.11 Division of Trusts. The trustee, in the trustee's absolute discretion, may divide a trust (the "initial trust") into two or more separate trusts and may segregate an addition to a trust (the "initial trust") as a separate trust.

(a) Funding. In dividing the initial trust, if the division is to be effective as of my death or as of the death of any other person, the trustee shall fund each separate trust with property having an aggregate fair market value fairly representative of the appreciation or depreciation in value from the date of such death to the date of division of all property subject to the division.

(b) Terms. A trust created pursuant to this paragraph shall have the same terms and conditions as the initial trust, and any reference to the initial trust in this instrument shall refer to the trust. The rights of beneficiaries shall be determined as if the trust and the initial trust were aggregated, except that: (1) different tax elections may be made as to the trusts; (2) disproportionate discretionary distributions may be made from the trusts; (3) taxes may be paid disproportionately from the trusts; (4) on termination, the share of a remainder beneficiary (including any recipient trust) may be satisfied with disproportionate distributions from the trusts; and (5) a beneficiary of the trusts may disclaim an interest in one of the trusts without having to disclaim an interest in another trust. In administering, investing, and distributing the assets of the trusts and in making tax elections, the trustee may consider differences in federal tax attributes and all other factors the trustee believes pertinent.

12.12 Accrued and Unpaid Income. On my death any accrued or unpaid income shall be added to principal, and except as otherwise specifically provided, on the death of any other beneficiary, income shall be paid as income to next beneficiary succeeding in interest.

12.13 Controlling Law. The validity and effect of each trust and the construction of this instrument and of each trust shall be determined in accordance with the laws of Illinois. The original situs and original place of administration of each trust shall also be Illinois, but the situs and place of administration of any trust may be transferred at any time or times to any place the trustee determines to be for the best interests of the trust.

12.14 Life Insurance. I retain during my life all rights under insurance policies payable to the trustee, including the right to change the beneficiaries and to assign any policies to any lender, including any trustee, as security for any loan. During my life the trustee shall not be responsible to pay premiums on any policy or to ensure that any policy remains in effect. After my death, the trustee shall take whatever action the trustee considers best to collect the proceeds of any policies then payable to the trustee, but the trustee need not incur expense or participate in legal proceedings unless the trustee is reimbursed from the trust or otherwise indemnified. Payment to and the receipt of the trustee shall be a full discharge of the liability of any insurance company, which need not take notice of this instrument or see to the application of any payment.

COMMENT

Article 12 provides various administrative provisions.

Paragraph 12.1 acknowledges that when the grantor dies the Lifetime Trust continues for some period until the various succeeding trusts are funded. The Lifetime Trust may be administered after the grantor's death without immediate funding of the other trusts, or those other trusts may be partially funded from time to time or completely funded at any time. Paragraph 12.1 also has language ensuring that the marital deduction is not jeopardized as a result of the winding up of the Lifetime Trust.

Paragraph 12.2 requires mandatory income payments to be made at least quarterly. This provision can be modified. Marital deduction requirements dictate that mandatory income payments be made at least annually.

Paragraph 12.3 establishes standards for discretionary payments. The trustee may consider other income and resources known to the trustee to be available to the beneficiary before making any discretionary payment of income or principal.

Paragraph 12.4 describes how both lifetime and testamentary powers of appointment are to be exercised. This provision gives the powerholder a great deal of flexibility in exercising a power of appointment.

Paragraph 12.5 contains several provisions that apply to the Marital Trust. Paragraph 12.5(a) allows a trustee to elect QTIP treatment over any part or all of any trust in which the spouse has a qualifying income interest for life. This includes the Marital Trust and, in this document, the Family Trust. As discussed under the Family Trust provisions, a partial QTIP election over the Family Trust may be desirable to eliminate state death tax in a decoupled jurisdiction. Partial QTIP treatment over the Marital Trust may be advantageous if the surviving spouse dies before the estate tax return for the grantor has been filed.

Paragraph 12.5(b) is a savings provision. It provides that the terms of the document are to be interpreted consistent with the Marital Trust qualifying for the marital deduction. Evolving tax laws and the possibility that courts may interpret already complicated tax provisions in ways that are now unforeseen argue strongly in favor of a savings clause. Note that the savings clause applies to all property for which a QTIP election is made. This property could include a portion of the Family Trust in this form.

Paragraph 12.5(c) requires the trustee of any marital deduction trust to convert unproductive property into property that produces a reasonable rate of income if the spouse directs. This sentence is necessary to ensure that any trust for which a marital deduction is elected (which could be either or both of the Marital Trust and the Family Trust) provides income payments to the spouse.

Paragraph 12.5(d) allows the spouse to disclaim a portion of the Marital Trust. The disclaimed portion of the Marital Trust is held as a separate trust, known as the "Disclaimer Trust," with terms similar to those of the Family Trust. Note that the spouse can have no power of appointment over disclaimed property. Code §2518(b)(4).

Paragraph 12.6 provides that distributions are not to be treated as advancements.

Paragraph 12.7 provides that for purposes of funding any trust, the trustee is to value each asset at fair market value as of date of distribution. Pecuniary gifts in trust or to the decedent's spouse include a pro rata share of the income from the date of death to the date of distribution. This paragraph is required not only to assure that pecuniary gifts to

a trust will qualify for the marital deduction but also to satisfy the separate share rules for generation-skipping transfer tax purposes when pecuniary payments are made.

Paragraph 12.8 groups together two provisions by which a trust might be terminated for legal or administrative reasons. Paragraph 12.8(a) allows a small or uneconomical trust to be terminated. The client can select any value to define a small trust; here the value is less than $100,000 as adjusted for inflation by a Consumer Price Index factor.

Paragraph 12.8(b) is a provision by which an Illinois trust opts out of the traditional and common law Rule Against Perpetuities under the Statute Concerning Perpetuities, 765 ILCS 305/1, et seq. The practice in Illinois is evolving into an opt-out of the Rule Against Perpetuities in all situations, even for those trusts that do not violate the Rule. However, in some cases all or a portion of the trust may have to terminate within the common-law Rule. Regardless of whether the trust terminates due to size or perpetuities, the distribution is to the income beneficiaries under Paragraph 12.8(c).

Paragraph 12.9 protects the interest of any beneficiary from creditors of the trust. Section 502(a) of the UTC also recognizes the validity of a spendthrift provision, but only if the provision prohibits both voluntary and involuntary transfers. Under Section 502(b), simply stating that the beneficiary's interest is held subject to a "spendthrift trust," or similar words, is sufficient to restrain both voluntary and involuntary transfers.

Despite general spendthrift provisions, the laws of many states permit a former spouse, or a child, to bring support claims against a trust. Also, federal law can preempt state law to allow certain tax obligations to be paid from a trust notwithstanding a spendthrift clause. Section 502(b) of the UTC recognizes these exceptions and adds another for a judgment creditor who has provided services for the protection of a beneficiary's interest in the trust. Section 105(b)(5) of the UTC provides that the grantor cannot override the effect of a spendthrift provision and the rights of certain creditors and assignees to reach a trust as provided in Article 5 of the UTC.

Paragraph 12.10 gives further flexibility to the trustee. It allows the trustee to combine trusts that are similar in their terms. It also allows the trustee to divide trusts into one or more separate trusts. This division is often helpful for various tax reasons, including the allocation of GST exemption. See also Section 417 of the UTC, providing that after notice to "qualified beneficiaries," a trustee may combine two or more trusts into a single trust or divide a trust into two or more separate trusts, if the result does not impair rights of any beneficiary or adversely affect achievement of the purposes of the trust.

Paragraph 12.11 provides that undistributed income is to be accumulated and added to principal. Absent this provision, state law is unclear as to how to treat undistributed income.

Paragraph 12.12 determines that Illinois law governs but allows the trustee to move the situs of the trust. Section 107(1) of the UTC permits the grantor to select any law to govern the trust, unless the designation of that jurisdiction's laws is contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue. Section 108(d) of the UTC requires the trustee to give notice to the qualified beneficiaries 60 days in advance of a proposed move, and terminates the trustee's authority to move the trust if any qualified beneficiary objects.

Paragraph 12.13 pertains to insurance policies and gives the trustee broad flexibility as to how to deal with and hold these policies in a trust.

Article 13
Payment of Death Taxes, Expenses, and Debts

13.1 **Payments.** After my death, the trustee shall pay the following:

(a) **Death Taxes.** All of my death taxes, except that any increase in my death taxes incurred as a result of property not held by this trust at the time of my death and (1) over which I have power of appointment, (2) with respect to which a qualified terminable interest election has been allowed, or (3) includible in my federal gross estate as a transfer with a retained interest, shall be paid by the person holding or receiving that property;

(b) **Expenses.** All expenses of my last illness, funeral, and burial; costs of safeguarding and delivering tangible personal property; and estate administration expenses; and

(c) **Debts.** All of my debts, other than debts secured by life insurance, by an interest in a land trust or cooperative, or by real property.

13.2 **Source of Payments Generally.** The trustee shall make all payments required under this Article from the principal of the Lifetime Trust remaining after distribution of any gifts of tangible personal property or gifts of specific assets or specific sums of money (including any pecuniary formula gifts), in trust or otherwise. If the cash and readily marketable assets in the Lifetime Trust are insufficient to make the foregoing payments in full, the trustee shall notify the executor of my estate of the amount of insufficiency and request payment. Notwithstanding the preceding two sentences:

(a) **Direct Skips.** The trustee shall pay from the disclaimed assets all generation-skipping transfer taxes on direct-skip transfers of which I am the transferor occurring at my death as a result of a disclaimer

(b) **Disclaimer.** The trustee shall pay from the disclaimed assets the amount by which my death taxes are increased by reason of a disclaimer of any portion of the Marital Trust;

(c) **Estate Management Expenses.** The trustee in its discretion may charge any part or all of my estate management expenses, as defined in the regulations for Code Section 2056, to the income of the Lifetime Trust;

(d) **Partial QTIP Election.** The trustee shall pay from the nonqualified assets of the Marital Trust the amount by which my death taxes are increased by reason of an election to qualify less than all of the Marital Trust as qualified terminable interest property; and

(e) **Retirement Interests.** To the extent necessary to qualify the trust as having a designated beneficiary with respect to retirement interests, the trustee shall not use retirement interests to pay death taxes or make any other payment under the preceding paragraph entitled “Payments;” provided that if the non-retirement interests in the trust are not sufficient to pay all taxes, debts, and expenses, those payments shall be made by the date prescribed in the regulations under Code Section 401(a)(9) for determining a designated beneficiary (currently September 30 of the year following the year of my death) to the extent practicable.

13.3 **Apportionment and Reimbursement for Death Taxes and Expenses.** Except as otherwise provided in the paragraph of this Article entitled "Payments," I waive all rights to reimbursement and apportionment.

13.4 **Tax Elections.** The trustee may make elections under tax laws and employee benefit plans and may make allocations of any available GST exemption as the trustee deems advisable. No adjustment shall be made between principal and income or in the relative interests of the beneficiaries to compensate for any such election or allocation.

13.5 **Payment of Trust Death Taxes for Beneficiary.** After my death, if any beneficiary of a trust created under this instrument dies, and any portion of the trust is includible in the beneficiary's gross estate for federal estate tax purposes, then unless the beneficiary expressly directs otherwise by will or trust specifically referring to this instrument, after the death of the beneficiary the trustee shall pay the trust death taxes from the portion of the trust so included. The "trust death taxes" shall be the trust's proportionate share of the aggregate amount by which the death taxes in the beneficiary's estate are increased as a result of the inclusion in the beneficiary's estate of (a) the trust property and (b) any other trust included in the beneficiary's estate, except for a revocable trust created by the beneficiary.

COMMENT

Article 13 deals with the payment of debts, taxes, and expenses. Under Paragraph 13.1 the trustee is directed to make all these payments, generally out of the residue, but is directed not to pay the increase in taxes resulting from power of appointment property, QTIP property, and property includible in the gross estate under Section 2036.

Under Paragraph 13.2 these payments are to be made from the principal of the Lifetime Trust remaining after the distribution of gifts of tangible personal property, specific gifts (if any) and gifts of specific sums of money, including any pecuniary formula gift (such as the Family Trust). If there are not enough assets in the Lifetime Trust (for example, in the case of an unfunded living trust), the trustee may request the executor to make payment. Section 505(a)(3) of the UTC provides that after the death of the grantor, and subject to the grantor's right to direct the source from which liabilities will be paid, the property of a trust that was revocable at the grantor's death is subject to certain probate claims if the probate estate is inadequate to pay them.

There are several exceptions to the general requirement that the residue bear the burden of taxes. First, the trustee is to pay from disclaimed assets the amount by which taxes are increased as a result of a disclaimer of the Marital Trust. Second, the trustee is to pay from any portion of the Marital Trust for which a QTIP election is not made the increase in taxes occasioned by the non-election. Further, all generation-skipping transfer taxes on direct skips resulting from a disclaimer are paid from the disclaimed assets.

Paragraph 13.3 waives all rights to reimbursement other than for the increase in taxes relating to QTIP, power of appointment and retained interest property referred to in Paragraph 13.1.

Paragraph 13.4 gives authority to the trustee to make tax elections.

Paragraph 13.5 relates to payment of death taxes attributable to property held in a trust under the instrument and includible in a beneficiary's estate. The trustee is directed to pay the increase in taxes. This will relate to the payment of taxes from a QTIP Marital Trust on the death of the spouse.

Article 14
Definitions

14.1 **Balance of the Trust property.** The "balance of the trust property" means the principal of the Lifetime Trust (including assets received from my probate estate or any other source) reduced by any payments of expenses, debts, and death taxes required to be paid from the Lifetime Trust and any gifts of specific assets and any pecuniary gifts (including any pecuniary formula gifts).

14.2 **Child and Descendant.**

(a) **Adopted Child.** A "child" of a person includes a child adopted by that person only if the person lawfully adopts the child prior to the child's attaining age 21.

(b) **Descendant.** A child of a person is a "descendant" of that person and of all ancestors of that person. A person's descendants include all such descendants whenever born. Except when distribution or allocation is directed to descendants per stirpes, the word "descendants" includes descendants of every degree whether or not a parent or more remote ancestor of a descendant is also living.

(c) **Child in Gestation.** A child in gestation on the date any allocation or distribution is to be made shall be deemed to be living on that date if the child is subsequently born alive and lives for at least 90 days.

14.3 **Code.** References to sections of the "Code" refer to the Internal Revenue Code of 1986, as amended from time to time, and include corresponding provisions of subsequent federal tax laws.

14.4 **Death Taxes.** "Death taxes" includes all estate, transfer, inheritance, and other succession taxes (including penalties and interest) imposed by reason of death. Death taxes shall not include generation-skipping transfer taxes imposed on any generation-skipping transfers other than direct-skip transfers made at the decedent's death of which the decedent is the transferor.

14.5 **Education.** "Education" means a preschool, grade school, middle school, high school, college, university, and professional or postgraduate education, any vocational studies or training, reasonable related living expenses, and reasonable travel expenses to and from the educational institution.

14.6 **Gifts.**

(a) **Annual Exclusion Gifts.** Annual Exclusion Gifts shall be made in such a manner as to qualify for the federal gift tax "annual exclusion" under Code §2503(b). Annual Exclusion Gifts to each person in any calendar year shall not exceed the maximum allowable amount of the annual exclusion for an unmarried donor or twice that amount if I am married at the time of the gift.

(b) **Tuition and Medical Exclusion Gifts.** Tuition and Medical Exclusion Gifts shall be made in such a manner as to qualify for the federal gift tax exclusion under Code §2503(e). "Tuition and Medical Exclusion Gifts" means amounts paid on behalf of a person as tuition to an educational organization for the education or training of that person or to a medical care provider for the medical care of that person.

14.7 **Incapacity.** A person (other than me) shall be considered incapacitated whenever the person is unable to give prompt and intelligent consideration to financial affairs or whenever a court has appointed someone to manage the peron's financial affairs. The existence of the inability may be determined by a physician, and any person may rely on written notice of the determination. A person already acting as trustee shall cease to act upon incapacity.

14.8 **Income Beneficiary.** An "income beneficiary" means a person to whom or for whose benefit income of any trust is or may be currently distributed.

14.9 **Independent Trustee.** An "Independent Trustee" means a qualified corporation, or a person who is not a beneficiary of the trust and who would not be considered a related or subordinate person under Code Section 672(c) as to any beneficiary under this instrument if that beneficiary were the grantor of the trust.

14.10 **Per Stirpes.** Whenever assets are to be allocated for or distributed to the descendants of a person *per stirpes*, those assets shall be divided into equal shares, one such share for each then-living child of that person and one such share for each deceased child of that person who has a descendant then living. Any such deceased child's share shall then be allocated for or distributed to that child's descendants *per stirpes* in accordance with the preceding sentence and this sentence.

14.11 **Qualified Corporation.** A "qualified corporation" means any bank, trust company, or other corporate entity that is authorized to act as a trustee and that would not be considered a related or subordinate party under Code Section 672(c) as to any beneficiary under this instrument if that beneficiary were a grantor of the trust.

14.12 **Retirement Interests.** "Retirement interests" means all employee benefit or annuity plans, contracts, custodial accounts, and other deferred compensation arrangements pertaining to employment, whether or not considered "qualified" under the Code, and all assets in those plans and my individual retirement accounts.

14.13 **Spouse.** The "spouse" of any person, other than me, means the individual legally married to, and not legally separated from, that person on the date of the distribution then in question or on the date of the prior death of that person.

14.14 **Tax-Sheltered Gift.** "Tax-sheltered gift" means:

(a) **Non-Qualified Assets.** Any assets that would not qualify for the federal estate tax marital deduction even if distributed outright to my spouse and that are not disposed of otherwise; and

(b) **Pecuniary Amount.** After considering other property passing at my death that does not qualify for the federal estate tax marital or charitable deduction in my estate, including the property described in (a), the largest pecuniary amount that results in no, or the least possible, federal estate tax payable by reason of my death, regardless of the amount of any state or local estate or inheritance tax that may be imposed at my death.

In determining the tax-sheltered gift, my executor shall consider any state death tax credit allowable to my estate (but only to the extent its use would not increase state death taxes), and shall assume that none of the Family Trust qualifies for the federal estate tax marital deduction and that all of the Marital Trust (including any part disclaimed) so qualifies. I recognize that the tax-sheltered gift may be zero, may be reduced by certain state death taxes, and may be affected by any election not to deduct administration expenses for federal estate tax purposes.

COMMENT

Article 14 provides definitions of terms used throughout the document. These definitions are placed at the end of the document so as not to distract the client from the over-all design of the estate plan, which is contained in the first 3 or 4 pages of the document. These definitions are important, however, and should be discussed with the client. Most of the definitions are straightforward. For example, the definition of "tax-sheltered gift" will not vary from document to document. The formula is drafted to account for changes in the tax law and to accommodate increases or decreases in the unified credit amount. As discussed earlier, it assumes that the client wishes to maximize the federal estate tax exemption equivalent, but allows the trustee to increase the marital deduction (if needed in a decoupled estate) in order to avoid state death taxes.

Paragraph 14.2, dealing with adopted children, should be considered for each client's situation. Under the laws of some states, a person adopted as an adult is nevertheless a "child" of the adopting parent. Under the form, only persons adopted before age 21 are "children." The client may wish to consider the age at which an adopted person is considered a beneficiary under the instrument. The definition of child can also be much more restrictive. For example, the document could deal with whether the term "descendant" includes children born out of wedlock, or via artificial insemination, or by surrogate parenthood, or by posthumous conception.

Prior to modifying or omitting any of the definitions in the form, the practitioner must carefully consider the impact of those changes on the document. Initially, consider how the definition is used in the document. Then consider the impact that changing the definition would have on the document.

For example, a client may read the definition of "tax-sheltered gift" in Paragraph 14.14 and determine that it has no applicability. The client may request the practitioner to delete that term from the document. If the term is deleted, however, this would render the formula in Article 3 useless. Therefore, although the definitions appear at the end of the document and may, as a result, attract less attention of the client, the definitions are critical to the workings of the document.

The term "balance of the trust property" is defined in Paragraph 14.1 to mean all principal of the lifetime trust reduced by debts, taxes, and expenses and reduced by all gifts. Its counterpart in a will is the "residue of the estate."

Paragraph 14.4 defines the "death taxes" to be paid from the trust to include estate, inheritance, and most generation-skipping transfer taxes.

Paragraph 14.5 provides a definition for "education." This definition can be expanded or contracted as the client deems prudent, but one must be cautious in expanding the

term's meaning. A creative definition of education that is overly broad might extend beyond the limits of an ascertainable standard under Code §2041.

Paragraph 14.6 defines annual exclusion gifts and tuition and medical exclusion gifts. These are the gifts that a trustee can make from the trust if the grantor is living but incapacitated. See Paragraph 2.1(c).

Paragraph 14.7 defines "incapacity" for anyone other than the grantor.

Paragraph 14.8 provides the definition of "income beneficiary."

Paragraph 14.9 defines an Independent Trustee as someone who is not a beneficiary of the trust or a related or subordinate party with respect to a beneficiary of the trust.

Paragraph 14.10 provides the definition for per stirpes. This definition is not often included in documents and should be helpful to practitioners when discussing the terms with clients.

Paragraph 14.11 defines "qualified corporation" to include most banks or trust companies authorized to act as trustee. This provision can be expanded to limit "qualified corporations" that can act as corporate trustee under the trust to corporations exceeding a certain minimum size.

Paragraph 14.12 defines retirement interests.

Paragraph 14.13 provides a definition of "spouse."

Paragraph 14.14 defines "Tax-sheltered gift" as previously discussed.

Article 15
Beneficiary's Occupancy of Residential Property in a Trust

The provisions of this Article shall apply after my death if the trustee of any trust retains or acquires any interest in property to be used by an income beneficiary as a residence ("the residence"). "Residence" includes a house, condominium (or the beneficial interest in a land trust that holds title to a house or condominium), cooperative apartment, or nursing home or retirement community arrangement, and any fractional interest therein.

15.1 **Retention and Use of Residence.** I authorize the trustee to retain the residence for the beneficiary's life notwithstanding that the residence may constitute a large part or all of the principal of the trust and may lack the diversification or productivity ordinarily considered prudent for trust investments. The beneficiary may occupy the residence rent-free, provided that the beneficiary pays all taxes, assessments, insurance premiums, ordinary repair bills, and other expenses of protecting and maintaining the residence. Notwithstanding the preceding sentence, if any expense payable by the beneficiary pursuant to the preceding sentence would be chargeable against the principal of a trust, the trustee shall distribute to the beneficiary as much of the principal of the trust as is necessary to reimburse the beneficiary for payment of such expense or, if requested to do so by the beneficiary, the trustee shall pay that expense directly from the principal of the trust. As long as the beneficiary pays expenses as required by the preceding two sentences of this paragraph, the trustee shall not sell the residence except as provided in the following paragraph.

15.2 **Sale and Purchase of Residence.** Upon the beneficiary's written request, the trustee shall sell all or any part of the residence for its fair market value and shall retain the proceeds of the sale as principal. On the beneficiary's written request, the trustee shall purchase or construct any new residence the beneficiary shall request out of the proceeds of any sale under this paragraph and shall thereafter hold the new residence as "the residence" subject to the provisions of this Article. The beneficiary at any time may purchase the residence from the trustee for its fair market value, which shall be determined as of the date the beneficiary delivers to the trustee a written purchase offer.

15.3 **Trustee's Liability.** No trustee shall be accountable for any loss sustained by reason of any action taken or omitted pursuant to this Article, and the powers granted under this Article shall be exercised only in a fiduciary capacity.

COMMENT

Article 15 provides how residential real estate held as part of a trust is to be administered for a beneficiary, including a surviving spouse. Because residential real estate is sometimes used to fund either (or both) the Family Trust and the Marital Trust, this provision has significant practical effect. It protects the spouse's reasonable expectations and gives the trustee flexibility in dealing with the residence. For example, Paragraph 15.1 allows the trustee to retain the residence for the beneficiary's life despite lack of trust diversification. It also directs how expenses are to be paid.

Paragraph 15.2 allows the beneficiary to direct the sale of the residence and purchase of another residence.

Paragraph 15.3 protects the trustee from liability.

Article 16
Captions and Context of Terms

Captions shall have no impact or meaning as to the terms of this instrument. Singular and plural and masculine, feminine, and neuter shall be interchangeable as required or permitted in the context of this instrument.

COMMENT

Article 17 provides that captions are not controlling and that singular and plural and masculine, feminine, and neuter terms in the document are to be considered interchangeable as required.

This instrument is signed on the date first above written.

JOHN DOE,
Individually and as trustee

COMMENT

The document is notarized so that it can be recorded, if necessary. Trust amendments likewise should be notarized.

STATE OF ILLINOIS)
) At this place
COUNTY OF COOK)

On _____, 2009, **JOHN DOE** personally appeared before me and acknowledged that this instrument was executed as that person's free act and deed.

_____
Notary Public

My commission expires:

This document was prepared by:

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