

By Brian K. Jones & Jerry D. Jones

Expect the Unexpected

Expanding the boundaries of traditional estate-planning documents

When attorneys draft trust documents, it's important to include maximum flexibility mechanisms to better respond to future tax, societal and beneficiary changes. Despite our clients' and our belief in crystal ball prognosis, these situations really are unforeseeable.

The current instability of the transfer tax system (gift, estate and generation-skipping transfer (GST) taxes) has wreaked havoc on traditional estate-planning practices. In the past, estate-planning documents could be constructed based on an established tax regime, in which we could anticipate future changes (through formulas) and proceed in an orderly manner. That's no longer the case. Gift and estate taxes weren't unified for five years before they were reunified starting in 2011. Also, exemptions were increased in 2011 and will potentially be decreased in 2013, and state estate and inheritance tax laws are across the board in application and not necessarily tied to federal estate tax rates. A new approach to estate planning is necessary to combat the instability of the transfer tax regime. That approach should also take into account the difficulty of predicting future cultural and beneficiary objectives. The same flexibility that's required for tax planning needs to be built into beneficiary (trust) planning.

Former U.S. Secretary of Defense Donald Rumsfeld once pondered to the press, "How do you know what you don't know?" Today, estate planners may look in the mirror and ask themselves, "How can we properly plan for clients and their families, perhaps into perpetuity, when we don't know what the rules will be in a year or two?"



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Improper Future Predictions

The "dead hand from the grave" has always been a poor solution. For example, the Chicago banker N.W. Harris' will prohibited investment in: (1) corporations that haven't paid dividends in each of the previous five years, and (2) real estate outside of Chicago's loop. While these may have seemed like sound restrictions at the time he executed his will, those requirements later frustrated the purposes of his testamentary trust and resulted in litigation to pave the way for needed relief.

Legislation is evolving that allows clients to ignore the rule against perpetuities (RAP) in planning, essentially allowing trusts to continue forever. Ironically, an unappreciated benefit of the RAP was that all trusts had a shelf life.² Restrictions that were considered appropriate when the document was executed, but which later became inappropriate with the passage of time (or changes in applicable law), were lifted de facto when the trust was required to vest and be distributed.

Examples abound of these cultural shifts in thinking. For example, legislatively and historically, adopted individuals weren't considered to be descendants or issue unless the trust agreement clearly stated an intent to include adoptees. If a trust created under these old rules was silent as to adoptees, are adoptees forever barred from receiving inheritances as the trust goes from one generation to another?³ Even when an attorney provides for flexibility in a document (for example, by including powers of appointment), he can't always anticipate cultural changes. A power exercisable in favor of descendants and spouses of descendants sounds benign enough—and inclusive. And expressive of intent. But science has and will continue to cause definitional problems. How would that power deal with frozen embryos and advancements in reproductive medicine? Furthermore, who's a spouse? Documents may limit the concept of a descendant's surviving spouse

to a person of the opposite sex, thereby denying beneficiary status to the non-descendant partner in a same-sex marriage. The picture becomes further blurred with the advent of sex change procedures, transgender developments and other shifts in gender that could occur.

Include Flexible Provisions

The solution when dealing with shifting estate tax, cultural and beneficiary changes: prepare documents (which are irrevocable upon execution or will become irrevocable upon death) that have sufficiently flexible provisions to allow a third party (including a beneficiary) to make future adjustments based on then-timely and contemporary ideas.

“Irrevocable” simply means that the settlor can’t revoke the document. “Unamendable” means the settlor can’t change the documents.⁴

Traditionally, beneficiaries have been given testamentary limited (non-taxable) powers of appointment to adjust a trust. The ability of a beneficiary to appoint property during life or at death to a class that excludes the beneficiary, his estate or the creditors of either, isn’t taxable if exercised at death. If exercised during life, there’s uncertainty as to whether the beneficiary exercising the power has made a gift.⁵

The problem with powers of appointment is that a beneficiary can’t change the disposition to himself. Further, documents often contain testamentary, but not lifetime, powers of appointment for a variety of reasons. A qualified terminable interest property (QTIP) marital trust, for example, can’t contain a lifetime power of appointment. Further, a credit shelter trust that’s structured to be used for state purposes as a state QTIP marital trust, also can’t have lifetime powers of appointment.

Practitioners need to go further, to that “Twilight Zone” sphere of drafting euphemistically referred to as the “trust protector.” Yes, it’s scary. But it’s not scary tax-wise. There’s no adverse estate tax consequence (yet, but beware of implied retentions) to allowing one who’s neither a beneficiary nor the settlor to have the power to change the trust (other than in a manner which could jeopardize a marital or charitable deduc-

tion or GST tax exemption, if applicable).⁶

And given the rapid evolution of tax law changes—who in the estate-planning community believed that billionaires who died in 2010 wouldn’t be subject to estate tax?—our documents need to be equipped to handle changing situations.

The Trust Protector

Trying to circumvent or limit the boundaries of a trust protector creates the same problem as not having one at all. How can we predict the future? A better solution is for the settlor to give the trust protector (or committee) the power to change the document, in a broad fashion, and to provide safeguards on this authority through an independent trust protector removal committee. Another unrelated individual (the “remover”), or small committee of individuals, could

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remove the trust protector (as well as the regular trustee) without cause.

The trust protector, as well as the remover, would be insulated from liability for serving in their respective roles, except as to gross negligence or beyond.⁷

The trust protector could make changes to the trust to bring it more in line with future social and moral developments, developments of the beneficiaries and societal changes, at the protector’s sole discretion. In addition, the trust protector also would be empowered to adjust the document to insulate it from future taxes (or to take advantage of the repeal of current taxes), neither of which may be anticipated as of the date the trust document is prepared.

In terms of changes in the beneficiaries, this gets more difficult. If the trust protector isn’t given the

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ability to modify the beneficiaries, he wouldn't be able to address the issue of adopted children discussed previously. On the other hand, shifting beneficial interests is a tricky power of hold, exercise and limit. One possibility is to allow the protector to increase or decrease beneficial enjoyment, while expanding the definition of beneficiaries to include evolving definitions of family.

This kind of drafting is avant-garde now. But much like a sale to the grantor trust in 1976, a burgeoning

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good idea slowly catches on, then becomes standard fare down the road. We predict that in the next 10 years, attorneys preparing irrevocable documents will include trust protector language as standard fare.

Protecting the Beneficiaries

In addition to having a trust protector step in to protect evolving beneficial needs, the trust document itself should be flexible and creative enough to understand a well-accepted paradigm: Even though enough money left to beneficiaries is a good thing, more than enough may not be better. In fact, more than enough may be fatal to a beneficiary's development and acceptance in society.

Trusts as Behavioral Vehicles

Traditionally, the structure of trusts has focused on reducing estate and income taxes, sheltering assets from divorce settlements and making beneficiaries judgment-proof. These are still worthy goals. In addition, focusing on how a trust impacts a beneficiary's behavior is now an important consideration of most clients. For example, parents want to know that the trusts they set up for their children don't foster bad behavior or lead beneficiaries to become the types of people their parents wouldn't have respected or wanted

to protect. Clients want to craft trusts that encourage good conduct and personal development.⁸

Attorneys should discuss estate planning with each client for individual development. The goal needn't be to accumulate the most wealth for the longest period of time, pay the least tax or leave divorced spouses with the smallest property settlements. The objective should be to provide to each beneficiary the ability to recognize his own potential and develop into the best person that he can be. That "best person" goal may be a stay-at-home parent, a supportive spouse, a student or just a good person who cares about others and is involved in the community. Becoming a teacher, nurse or social worker (critical, but traditionally low-salaried positions) would be ideal professions for trust beneficiaries who would still then be able to support their families. Preserving or increasing wealth as a goal unto itself, not linked to some greater good, is like a prosecutor striving for a perfect conviction record without regard to justice.⁹

The corollary of making distributions to encourage a beneficiary to become, or continue to be, a good person, is reducing or eliminating distributions when a beneficiary regularly displays bad behavior and makes little or no effort to change. A tough love approach also should be part of every trust distribution policy.

Each Beneficiary is Different

One size doesn't fit each beneficiary similarly situated in the family tree. A critical part of estate planning and trust administration should be to continue doing what the benefactor would have done had the benefactor still been around to make those decisions. For example, a parent may pay for college and graduate or professional school for a highly motivated child, yet never feel compelled to distribute a sum of money equal to those education costs to another child who had no interest in pursuing higher education.

Parents don't think in terms of automatic equal distributions to, or for the benefit of, each child. The trustee should focus on providing the means for each beneficiary to live up to his full potential. The starting point for this needs to be the trust document, and this can be achieved through six suggested steps:

1. **Prepare letter of instructions to trustee.** Encourage the settlor to prepare a letter of instructions to the trustee outlining in very

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broad strokes, preferably in the settlor's own words, the settlor's goals for use of the trust fund and the types of conduct or development the settlor wants to reward or discourage.

2. Determine distribution standard. The estate-planning attorney must then determine the distribution standard. A broad standard tied to a distribution that the trustee deems "advisable" is one approach. More detailed provisions expanding on this standard could make it clear that no distribution is required to be made and that all or any portion of the income may be accumulated and added to principal.

"Best interest" of members of the class of persons to whom distributions may be made is intentionally deleted from the standard, since we're concerned that a court would construe that broad standard to refer to a beneficiary's physical or financial comfort rather than the beneficiary's personal development.

3. Provide incentives. Estate planners should discuss with clients the option of providing incentives for the beneficiary's personal (not just professional) development and imposing consequences for continued bad behavior.

4. Choose appropriate trustee. Choosing the appropriate trustee is paramount to the plan's execution. Most important is choosing someone with common sense and business acumen who can hire and fire the right professionals and be able to say "no" to an ill-conceived beneficiary request.

In deciding between an individual and corporate trustee, the client must interview both to ensure that they will act consistently with the client's intent despite pressure from the beneficiary. For an institutional trustee, will principal invasions be subject to a different review than is normally given by the distribution committee? Will an individual trustee (or committee of trustees) pay sufficient attention?

A negotiated fee for this service should be considered at the time of drafting.

Because these trusts are a bit out of the mainstream, we've had good experiences when the trustees are made up of a group of individuals and family advisors (rather than solely institutional employees). A corollary is that the attorney should begin discussions with corporate trustees as to the value of these trusts to get them on board with acting in this new-age capacity.

5. Include removal power. The family's safety valve

is to have a different individual (or group of individuals) empowered to remove the distribution decision-making individual co-trustee (or group of family advisors).

6. Use separate trusts. It's also advisable to allow separate trusts for each family line and to give the oldest generation in each family line a broad (but non-taxable) testamentary power of appointment to change any of the terms of the trust designated by the oldest generation's name. **TE**

Endnotes

1. www.defense.gov/transcripts/transcript.aspx?transcriptid=2636.
2. See *Duke of Norfolk*, 22 ER 931 (1682) (shifting title to property beyond lives in being disallowed).
3. States have legislatively attempted to fix the problem of adopted children with these older documents. See, e.g., 755 ILCS 5/2-4(f) (children adopted prior to 1955 are deemed, except in special circumstances, to be a child born to the adopting person).
4. See 26 U.S.C. 2036 and 2038. Typically, the settlor also has renounced the right to alter or amend the document and has retained no other right or power that, under current law, would cause the value of the trust to be included in the settlor's gross estate at death for federal estate tax purposes.
5. 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 Internal Revenue Service 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 Treasury Regulations Sections 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). An attorney should understand and discuss this possible gift tax issue with the client before any lifetime power is exercised, especially because the IRS has announced that it won't follow *Self*. Revenue Ruling 79-327, 1979-2 C.B. 342.
6. See, e.g., 26 U.S.C. 2041, in which the power in a third party to change the terms of a marital trust would be deemed to create a non-qualified terminable interest, thereby invalidating the marital deduction.
7. Such trust protector would likely have a fiduciary duty to the beneficiaries. See Comment e to *Restatement (Second) of Trusts* Section 185, which states, "If the power is for the benefit of someone other than the holder of the power, the holder of the power is subject to a fiduciary duty in the exercise of the power."
8. Some behavioral scientists think that trusts that create incentives to encourage beneficiaries to engage in certain behavior don't always succeed. See Daniel Pink, *Drive: The Surprising Truth about What Motivates Us* (New York: Penguin, 2009).
9. "The duty of a public prosecutor is to seek justice, not merely to convict." See Rule 3.8, Illinois Rules of Professional Conduct of 2010.