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BASICS ABOUT TRUSTS IN PLAIN ENGLISH

I. What's Included in My Estate:

Basically all of your stuff! This includes bank accounts, money market accounts, CDs, your house, other real estate (from any state), cars and recreational vehicles (not leased), IRAs and retirement plans, and life insurance death benefits (unless the policy is owned by someone other than you or your spouse, or it's in an Irrevocable Insurance Trust.)

II. Reasons to Have a Revocable Trust:

A. Minimize estate taxes

B. Avoid Probate:

1. Note: only assets properly titled in the name of your trust avoid probate at your death. If you forget to title an asset in the trust name, there is a probate first and then it goes to the trust and is passed out per the trust terms. If you own real property in other states and it's not titled in your trust, there must be a separate probate in each such state. Bad idea.

2. Note: Generally, DO NOT title your Revocable Trust as beneficiary of IRAs or Retirement Plans. These assets already avoid probate. Also, you lose the ability for non-spouse beneficiaries to use their own life expectancy for distributions. This means they may have to pay income taxes on the whole thing right away! The IRS allows people to name their Revocable Trust as beneficiary if certain easy requirements are met. This is because they LOVE IT if they get more income tax right away. Don't fall for that trap.

3. Control Asset Distribution to Children/Grandchildren: A trust allows you to be creative regarding the terms of the distribution of your assets. As described more fully in III f., you can be as strict or lenient as you want to. Distributions can occur over 3 generations, or they can be 100% outright immediately upon your death. You choose.

C. Allow a step-up in basis: Your basis is what you paid for something. If your heirs (spouse, children) inherit an asset from a trust, they get a "step-up" in basis to the fair market value of the asset as of the day you die. This means that heirs can sell the property after your death for its fair market value and pay NO CAPITAL GAINS TAX! This is a potentially huge income tax savings. For example, you pay $100,000 for some real property. When you die, it is worth $1,000,000. Your heirs can sell the property for up to $1,000,000 and avoid the 15% capital gains tax. This is a tax savings of approximately $135,000.

WARNING: Property held in joint tenancy may avoid probate, but the surviving owner loses the step-up in basis. BAD IDEA!

III. Estate Tax:

A. Is owed only if the value of your "stuff" exceeds the applicable unified credit in the year you die. On that exact day, they appraise all your assets to see if the value is over the unified credit. Exception: exactly 6 months later, if the total asset values are less, you can use the lower value for estate tax.

B. Unified Credit is the amount you can pass on to non-spouse beneficiaries estate tax free and for 2020 it is $11,580.00. This amount changes every year.

C. Unlimited Marital Deduction:

If you are married, there is never any estate tax, no matter how much $$, until the death of the second spouse if you use the marital deduction. This means the surviving spouse has to get the income from a QTIP trust or, if a Bypass Trust have the right to the income which she may choose not to take out. In our hypothetical, the surviving spouse is the wife. We are not sexist, but people usually assume the husband will die first! If you leave everything outright to the surviving spouse, then you lose one unified credit for your ultimate heirs. No estate tax would be owed until death of the surviving spouse, but only one unified credit gets used in the year of her death. Not the best strategy.

D. Subtrusts: to allow the surviving spouse to access the funds (other than her ½ of community property and her separate property) since the surviving spouse might live a long time and need all of the $$, and yet still get the benefit of 2 unified credits for children, you set up subtrusts at the death of the first spouse. Usually, the surviving spouse and the estate attorney select which assets to title in the name of each subtrust at the time of the first spouse's death. Since 2012, the estate tax credit of a deceased spouse is "portable" to the surviving spouse. This means that sub-trusts are not required to preserve the deceased spouse's estate tax credit as in the past. So long as the surviving spouse files an estate tax return (a "706") even if the estate is much smaller than the estate tax credit, and does not remarry, the estate tax credit of the first spouse to die is preserved.

Typical subtrusts are as follows:

1. A-B - Marital GPA:

The A Trust (also, Survivor's Trust) holds surviving spouse's ½ of community property and her separate property.

The B Trust (also Bypass Trust, or Decedent's Trust) holds an amount up to the applicable unified credit in the year of the first spouse's death. If deceased spouse's ½ community property and his separate property is less than unified credit, then that amount all goes to this subtrust. Administering the B Trust is a bit of a pain because the surviving spouse can usually only access these funds if her surviving part is not enough. Also, the ultimate beneficiaries cannot be changed. That is often good. Except, what if a beneficiary has creditor or divorce issues and surviving spouse wants to make distributions tighter? The B Trust can have a Special Power of Appointment (SPA) which allows surviving spouse to delete beneficiaries or tighten the terms, if the spouses fully trust each other, to prevent such an occurrence.

Be careful! Any income left in the Bypass trust is taxed at the highest income tax rate (39.6%). Better to pay out all the income to the surviving spouse at a lower bracket.

Marital Trust (GPA):

First, you need to understand that a GPA (general power of appointment) causes all the property involved to be included in the estate of the person holding this power. Thus, if you give your spouse a GPA over the marital trust, she can generally exercise that power in many ways, including changing the beneficiaries or restricting their rights after your death. If the deceased spouse's ½ community property and separate property exceed the unified credit, then the rest goes to this subtrust. At the first death, if assets are less than that, this one is never actually created. The Surviving spouse must have the right to get all income from this trust and have a power of appointment to get the unlimited marital deduction (i.e., a "GPA"). This means that she has control over ultimate distribution to anyone from this subtrust. The Surviving spouse can remarry and leave this amount to new family, etc. Use when stable marriage and no issues re children from prior marriage.

Ex 1: $1,000,000 estate. All is community property. Spouse 1 dies in 2002 when unified credit is $1,000,000.

A Trust:	$500,000
B Trust:	$500,000
Marital Trust:	-0-

Ex 2: $2,500,000 estate. All is community property. Spouse 1 dies in 2002

A Trust:	$1,250,000
B Trust:	$1,000,000
Marital Trust:	$ 250,000

2. A-B-QTIP (Qualified Terminable Interest): The A and B parts are the same. But instead of a Marital Trust which gives the surviving spouse a GPA, the QTIP ties up the funds in this subtrust. All of the income in the QTIP <u>MUST</u> be paid out to the surviving spouse, but the principal is only accessed for her if the A trust is insufficient. She cannot change the ultimate beneficiaries. Use this subtrust when there is a second marriage and children from first marriage. Even in these situations, if the second spouse is trusted, they may not want to tie up the funds.

Ex 1: $2,500,000 estate. All is community property. Spouse 1 dies in 2002.

A Trust:	$1,250,000
B Trust:	$1,000,000
QTIP:	$ 250,000

3. A-Disclaimer Trust: With the estate tax reduction, this scenario will be very common.
A trust is the same. Since the unified credit is going up so much, it's likely that no estate tax is anticipated in fairly large estates (approximately $10,000,000) and settlors prefer not to tie parts of the estate up in AB or QTIP trusts.

All to surviving spouse's A trust, if it's likely there will be no estate tax anticipated at death of second spouse and spouses trust each other. If at, the death of the first spouse, the surviving spouse thinks there might be estate tax at her death, she can disclaim a part of the estate to a Bypass Trust, which she can still access if needed but will go to children at second spouse's death and get benefit of using up all or part of 2 unified credits.

A disclaimer is when the spouse steps aside from inheriting all or a portion of the deceased settlor's estate. It must be done within 9 months of the date of death. It's as though the surviving spouse died first and didn't ever inherit the disclaimed piece. The next named beneficiaries in line step up to first place. But because the surviving spouse might live a long time, you put the disclaimed funds into a Bypass Trust, so she could access the $ if necessary.

Ex 1: A-Disclaimer
estate $2,000,000. Spouse 1 dies in 2006 when unified credit is $2,000,000
A Trust: 100% - no estate tax anyway

Ex 2: estate $2,000,000. Spouse 1 dies in 2004 when unified credit is $1,500,000
A Trust: $1,500,000
Disclaim to B Trust: $ 500,000 (if surviving spouse wants to)

4. QDOT (Qualified Domestic Trust): If one spouse is not a citizen, the A and B trust (if you even want a B trust) operate the same as above. But the Marital Trust (if the surviving spouse is not a citizen) must be a QDOT. This is because the marital trust normally qualifies for the unlimited marital deduction and gives the surviving spouse a GPA. Thus, she could skip town and never pay estate tax on the marital trust at her death. The IRS requires that a surviving spouse have a US citizen as trustee over a marital trust. Of course, she has control anyway over her A trust, since that is her property to do with as she pleases.
ALWAYS confirm in writing if both married clients are US Citizens. You never know otherwise.

Ex: Non-US Citizen is surviving spouse. $3,000,000 estate and spouse 1 (who is US Citizen) dies in 2001, when unified credit is $1,000,000. All is community property.

A Trust:	$1,500,000
B Trust:	$1,000,000
QDOT:	$ 500,000

E. Single Settlor: Obviously, there is no marital deduction, so person can pass on 1 unified credit's worth of his stuff to heirs. Amounts in estate exceeding that are subject to estate tax. This applies to same sex relationships too.

F. Distribution Choices to Ultimate Beneficiaries, Children/Grandchildren:
This really varies greatly depending on the level of responsibility the children have. You need to know about their ability to handle $, possible creditor issues, possible divorce or just that the settlor doesn't really like or trust the child's spouse.

1. Outright to Children: Fine if no problems. Usually "per stirpes" which means that if the child predeceases settlor, then his or her issue gets his or her share (i.e., grandchildren), otherwise if no issue, to siblings. "Per Capita" means if child predeceases settlor, his or her share does NOT go to issue, but instead pro rata to siblings/other trust beneficiaries.

2. **HEMS (health, education, maintenance, support):** the trustee (typically someone other than child) passes out $ over child's life for HEMS. The child has no automatic right to funds. It's the trustee's choice pursuant to the ascertainable standard. This is a very strong protection for the beneficiaries but may not block all creditors, for example alimony. Because the child could be stuck with a trustee making bad decisions, I often give adult child beneficiaries the ability to fire the trustee every 2 or 3 years and pick a new CORPORATE trustee (not his or her spouse or friend). A trust protector can also be given the power to remove the trustee.

(i) option: at certain ages, child can take out a % of funds in his or her share (Ex., 1/3 at 30, 1/3 at 35 and rest at 40).

(ii) option: if children have problems, you may not want them to have a GPA power to appoint their share to persons other than the grandchildren because they're not that stable. Also, remember that generally you want children to have a GPA so it's included in their estate if there is any possibility of a generation skipping transfer tax, and not included in grandchildren's estate inadvertently. You can give them a GPA ONLY to CREDITORS. NO ONE EVER leaves his or her estate to "my creditors" so this is pretty safe. If they don't, then it goes automatically to issue without generation skipping tax problems.

(iii) distributions tied to child's W-2 income for any given year. This is pretty mean, but it gives the child incentive to work. So if he earns $100,000 in any given year, that amount is matched as a distribution from the trust. If he is lazy and earns $5,000, that's what he gets from the trust. This is only for fairly large estates where you want a work incentive for children.

3. **Discretionary Trust** is even tighter than No. 2 (HEMS), because the trustee has the sole discretion to distribute or hold back whatever amounts the trustee elects. This is the strongest protection from all claims of potential creditors of the beneficiaries, including alimony and other claims from divorce. Again, there should be checks and balances to allow for removal and replacement of the trustee, if necessary.

4. **Pot Trust:** If children are minors, in case parents die while they are still young, the funds are held in a single "Pot" for HEMS until the youngest reaches an age when you think they should be done with school. At that age they should get their share divided out separately and either held for HEMS or allow them a right to withdraw fractions of share at different ages.

This recognizes that young children are really not "formed" yet and you don't know which child will have greater education needs or health issues, etc.

5. **Generation Skipping:** If you want to leave $$ directly to grandchildren (or children) can get income for their lives and then to grandchildren) you have to make sure you do not exceed the $5,430,000 Generation Skipping Transfer Exemption amount. If there is any possibility of the

amount going to grandchildren exceeding this, be careful. This is a <u>single</u> $5,430,000 total per person for any # of grandchildren collectively). Excess amounts are subject to a 50% penalty on top of estate tax and income tax!

Generation skipping can also apply to bequests to other non-grandchildren, like nephews or nieces, who are more than 37 ½ years younger.

Also, if you leave assets to a child to be held for life (pursuant to Nos. 2 and 3 above) and then to the child's issue (i.e. your grandchildren), it could be generation skipping if the child does not have a general power of appointment. A general power of appointment means that the inheritance will be counted in the child's estate. Also it means the child has a broad power to direct who gets the inheritance after he or she dies.

The premise for generation skipping is that no estate tax will be due on the GROWTH until the grandchildren die. This does not avoid or reduce any estate tax that may be due at your death. Instead it defers estate tax on the growth for a whole generation. In the old days, the industrial barons used to leave $ to unlimited generations, and the IRS got tired of waiting for grandchildren and great-grandchildren to die. So they imposed a generation skipping tax to strongly discourage this practice. Also, the Rule Against Perpetuities says basically you can't leave assets for more than 3 generations (or 130 years).

III. Other Types of Trusts:

A. ILIT (Irrevocable Insurance Trust): The Trust owns a life insurance policy on settlor/insured's life. This results in the death benefits NOT included in settlor's estate. Normally, a life insurance policy on your life with a death benefit of $1,000,000 avoids probate when you die because the beneficiaries receive the $$ directly. However, the death benefit is included in your estate, as part of your "stuff," and is subject to estate tax. This often is not expected or intended.

The alternative is to have the trustee of the ILIT (someone other than settlor or spouse) actually buy the policy in the name of the ILIT. The premiums come from the settlor, who writes a check to the trustee. This counts as gifts to beneficiaries. If the premium total is under $14,000 for each beneficiary, it is gift-tax free. If the premium is more than $14,000 each beneficiary, the premium amount in excess of that is considered a gift, and a gift tax return must be filed (709 return). This eats up Settlor's unified credit, but no actual gift tax has to be paid unless settlor has used up all of his unified credit and the premiums are now beyond that.

If settlor already has an insurance policy that he has purchased the usual way, he can transfer it to the ILIT and, if he lives 3 years after the transfer, it is out of his estate. Be careful, if an existing policy has cash value, a transfer may be considered a gift to the beneficiaries. Term insurance usually has $0 cash value.

B. Education Trusts/Irrevocable Children's or Grandchildren's Trust: Often, people gift to children and grandchildren directly or to an UTMA account (Uniform Transfer to Minors Account). Direct gifting is fine, so long as the beneficiary is stable and has no creditor or divorce issues. Also, an UTMA account is OK but the beneficiary has the right to withdraw all the account once he or she is 21. Many heirs are not quite fully responsible at that age, so it may not be the best scenario.

A good alternative is to gift the money to an Irrevocable Trust for the benefit of a particular beneficiary or beneficiaries. The settlor is not the trustee, and the gifts can have as many strings attached as settlor wants. For example, to be safe, the trustee can pass out the money to the beneficiary for HEMS (Health, Education, Maintenance or support). This is great because the beneficiary cannot spend all the $$ at once. However, the risk is that the trustee will be too tight with distributions. The solution is to have the trust language include the power for adult beneficiaries or a trust protector to fire the trustee and pick a new CORPORATE trustee every 2 or 3 years, but they cannot pick their spouse. The next trustee must be a professional corporate trustee, like a bank or investment company, or sometimes specified professionals. These trusts are spendthrift trusts and are protected from creditors of the children beneficiaries.

Note: Your own revocable trust does <u>not</u> provide you with any creditor protection. It is your stuff, after all. But beneficiaries of revocable trusts are protected once you die, and the trust is irrevocable. This is better than outright distributions to beneficiaries which allow for no creditor protection, once the assets are distributed.

C. IBRAT^{SM} (IRA Beneficiary Restricted Access Trust): This is a special type of trust which holds IRA or retirement plan distributions for children or grandchildren beneficiaries once the IRA owner dies.

Normally, if you name children or grandchildren (being careful not to exceed GST) beneficiaries to your IRA or Qualified Retirement Plan, they have a choice at your death, to pay income tax on the whole thing and take a 100% distribution, or they can take out distributions a little at a time over their life expectancies according to IRS tables. The latter approach is obviously the best choice, since it defers income tax on the distributions and allows the tax deferred geometric compounding to continue for the life expectancy of the beneficiary. Sadly enough, most beneficiaries do not pick the better distribution choice, either because they are not advised properly or because they are greedy. By naming an IBRAT as the beneficiary, you can <u>force</u> them to take distributions over their life expectancy. This protects them from creditors and divorce, since most of the money will be held in the IRA and only paid out a little bit at a time. If the child dies before the end of the term, then his children (your grandchildren) gets payouts over the rest of the same term.

There are two types of IBRATS^{SM}:

1) IBRAT^{SM} Conduit Trust. This ensures that the beneficiary won't take out a greater contribution that the Annual Required Minimum Distribution (RMD) unless the trustee agrees that more is needed for a good reason. Thus, the principal that is not distributed continues to compound tax deferred to the greatest extent possible.

2) IBRAT Accumulation Trust. This allows the same control over RMDs, but also allows the trustee to <u>hold</u> the distributions if there is a risk of them being attacked by the beneficiary's creditors once a distribution is paid out.

D. FLPs (Family Limited Partnerships): Gives the settlor a 35 - 45% discount on estate tax owed for whatever is in the FLP if the settlor is a minority partner at the time of his or her death. Typically, you only use these where there are substantial personally held investments or real estate and it is expected that the settlor's estate will have some significant estate taxes (married settlors anticipate estate tax at death of second spouse). DO NOT USE for IRAs, Retirement Plan or Insurance.

The IRS generally finds that if a minority partner tries to sell his minority interest on the free market, no buyer would pay market price for the shares, because he has no control. This technique is not usually necessary for estates for married settlors of less than $10,000,000 (single settlors $5,000,000). They are expensive to set up and have a lot of technical rules for proper record keeping thereafter, so it is not for everyone.

Also, LLC's can be used for the same purpose and may provide greater flexibility than FLP's.

E. Nevada Asset Protected Trusts: This new type of trust was created by Nevada legislature in October 1999. Currently 15 states have a self-settled asset protection trust. The law is constantly changing in this area. It basically allows the settlors (the people who make the trust) to have creditor protection for themselves during their lives.

A normal revocable trust does <u>not</u> provide any creditor protection for the settlors. It's just their assets and they have no extra layer of protection simply by transferring assets to their revocable trust.

The Nevada Asset Protected Trust allows the trust owners to be beneficiaries of their own trust and later, the ultimate beneficiaries may be children and grandchildren. Creditor protection is generally effective for the current and future creditors 2 years after an asset is transferred to the trust and the potential creditors are usually given notice by a newspaper publication noting the date of funding. This publication starts the 2 year clock ticking.

This trust is ideal for people who have significant personally held investment portfolios and/or Nevada real estate. Since IRAs and Qualified Retirement Plans are already creditor protected, retirement assets do <u>not</u> go to this type of trust. Also, real estate in other states should not be transferred directly to a Nevada Asset Protected Trust because case law is evolving whereby assets held in states <u>other</u> than the trust jurisdiction state, are not required to honor the statutory protection from another state's statute. Sometimes, it may be effective to have real property from other states owned by a Nevada Limited Liability Company and the member could be the Nevada Asset Protected Trust.

Nevada Asset Protected Trusts are <u>irrevocable</u>, meaning once created, they cannot be amended or changed. Also, a Nevada Independent Trustee (not the trust settlors) serves as a co-trustee and basically rejects creditor inquiries. An outside trustee means trustee fees. So, expect an annual trustee cost to maintain this trust.

The settlors (and sometimes also the outside trustee) serve as the Resources Trustee. This is the trustee who selects investments. There must also be a Nevada Independent Trustee who does not control investments, but is able to veto distributions if a creditor attempts to pierce the trust.

Another great use of Nevada Asset Protected Trust is for large personal injury settlements or judgments. Typically, a plaintiff was seriously injured and gets a lump sum payment or a series of payments over time. If the person is not used to handling large sums of money, he or she may be a sitting duck for all kinds of investment schemes. The independent trustee protects against this.

A final interesting use of a Nevada Asset Protected Trust is for an adult child who has already received gifts from wealthy parents. The parents now prefer to protect the child from potential creditors or divorce. To the extent the child agrees (because he wants to keep receiving gifts), he can voluntarily fund the already completed gifts to a Nevada Asset Protected Trust. Any further gifts can go straight to the same trust.

These trusts can be phenomenally useful for the right people who have large personally held investment portfolios. In this litigious society, you can never have too much creditor protection.