FINE-TUNING DYNASTY TRUSTS AS THE CENTERPIECE OF THE FAMILY WEALTH PLAN

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Dynasty trusts, which permit inter- and multi-generational wealth management, are more effective than traditional trusts.

How many times has an estate planner heard the common refrain from a client at that first meeting - - "All I want is a simple will."[1] How often has the attorney who dabbles in estate planning defended the will he or she routinely employs by explaining, "My clients don't want the complexities of trusts." This attitude has become even more prevalent with the current exemption, $5,250,000 for a single person and $10,500,000 for a married couple. Since clients feel they are not exposed to estate taxes, many of them no longer believe there is a need for trusts. Even skilled practitioners may be inclined to accept their clients' summary dismissal of the trust vehicle, especially if estate taxes are no longer a concern. However, it should be remembered that while saving taxes is frequently an important objective, it is only one of many goals that can be accomplished for the client through the use of a trust. Moreover, even if estate taxes would not be applicable, trusts can often save considerable income taxes.

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This reflexive resistance to trusts[2] is actually doing the client a disservice and is based on several glaringly faulty assumptions. Certainly, a will can be simple.[3] If simple and standardized, it can also be rather inexpensive. The problem is that a simple will fails to assure that the intended beneficiaries[4] really will be able to use and enjoy the property as the decedent intended and that "predators"—such as creditors, a current or former spouse, deceitful investment advisors and the government—do not sooner or later reach it instead.[5] In other words, it is an illusion to naively believe that the client's goals necessarily have been accomplished simply because the intended beneficiaries *received* the property.

Is the trust a viable alternative, however? The critique usually leveled against trusts is that they are "too complex;"[6] that they are inflexible; that they entail surrender of control to outsiders; and that they are comparatively expensive, both in terms of their creation and ongoing administration. It is perceived that trusts are the exclusive preserve of the exceptionally wealthy, who turn to trusts when they have no other alternative to preserve their wealth and dynastic aspirations.[7]

In fact, the trust is almost always better suited to achieve the client's goals, even for clients with a net worth well below the estate tax exemption. Clients have what might be described as a postmortem "wish list." That is not to say that a client will walk into the estate planner's office and promptly rattle off the list—rather, the clients' goals are inherent in the hopes and concerns expressed, if only in a general manner to the advisor. So, what are the goals on that typical wish list?

1. *Managerial control.* Handing over management control of assets, in varying degrees, to descendants, subject to their capabilities, maturity, and respect for values crucial to the client. This includes investment and business decisions.
2. *Use of and enjoyment of trust assets.* Use and enjoyment of the trust assets until death with the primary beneficiaries using them in preference to younger generation beneficiaries. In the case of real property, that means, literally, use of premises. In the case of intangible assets, it means distribution of some of the income and/or principal, while retaining the rest until needed.
3. *Flexibility.* The ability to make changes in the future to take account of changing circumstances, both with respect to family members, e.g., to take into account that a future descendant may have "special needs," and exogenous factors like changing tax and other laws,[8]
4. *Creditor protection.* Protection of the beneficiaries' inherited wealth from claimants, notably creditors and divorcing or divorced spouses.[9]
5. *Tax savings.* Reducing the tax burden, both estate and income taxes, at the federal, state, and local levels, so that inheritances are not unduly diminished.
6. *Avoiding complexity.* Relative simplicity of the plan, so that the preceding wishes can be attained, without the need for endless, expensive consultations with the estate planner or trustee, which too often tend to leave the client and other family members overwhelmed and frustrated.

The virtues of the trust

With respect to the client wish list, the simple will distributing wealth outright, provides the recipient with control, use, and certain flexibility, but does not provide any protection from taxes and creditors. Arguably, it provides simplicity. However, this simplicity often is illusory—being true initially, but not sustained over time. A trust created by somebody else is the best (and, for that reason, generally the simplest) estate[10] and asset protection plan for the beneficiary. The other goals cannot be satisfied, because the simple will operates to distribute inheritances outright at the

1 See Manterfield, "Ethical Issues for Estate Planning and Family Business Succession Advisors," Estate Planning For The Family Business Owner, SS008 ALI-ABA 913, 959 (6/7-9/10) ("Most clients seek assistance in the preparation of a 'short, simple will.' No client comes in with the request that the advisors prepare 'a really complicated estate plan!'").

2 In some cases, the client and planner may not so much resist the trust as simply overlook it. Aucutt, "Structuring Trust Arrangements for Flexibility," 35 U. of Miami Inst. on Est. Plan., ¶ 900 (2001) ("The old refrain, 'All I want is a simple will,' helps explain why so many people, including many advisors who should know better, so often overlook trusts when planning for the transfer of wealth as an inheritance within the family.").

3 See, however, Pennell, "Ethics Issues for Estate Planners," Estate Planning in Depth, SU036 ALI-ABA 1045, 1086 (6/23-28/13) ("Nevertheless, many attorneys still believe that anyone can draft a 'simple will,' notwithstanding the reality, in the current estate planning environment, that there are short wills and simple lawyers but probably no simple wills.").

4 When a client intends to pass on wealth, it is generally to the client's children, grandchildren, and even subsequent generations. In this article, they are referred to by several terms, such as the client's beneficiaries, the client's descendants, or the client's inheritors.

5 Aucutt, *supra* note 2 ("In the rush to achieve simplicity, such persons fail to realize the *enormous*, *unnecessary* and *irretrievable loss* of assets (to taxes, divorce, and creditors) that many *families will suffer* for failure to appreciate the protections that a trust can provide when passing wealth from generation to generation.") (emphasis added).

6 The classic pronouncement along these lines was made by Supreme Court Justice Sandra Day O'Connor in her opinion for the Court in Hodel v. Irving, 481 U.S. 704 (1987). Explaining why an inter vivos revocable trust is not a satisfactory alternative to a right to transfer property at death by will or intestacy, she naively stated: "The fact that it may be possible for the owners of these interests to effectively control disposition upon death through complex *inter vivos* transactions such as revocable trusts is simply not an adequate substitute."

7 In fact, even in the case of a small estate, a trust may be justified. Consider a young couple with minor children, ages 4 and 7, who have a total estate, including life insurance, of a modest amount. If the parents were to die prematurely, having a trust in place would be preferable to other alternatives for wealth management. See Oshins and Oshins, "Protecting & Preserving Wealth into the Next Millennium," 137 Trusts & Estates 52 n.17 (September 1998). See also Dukeminier and Sitkoff, *Wills, Trusts, and Estates 9th Ed.* (Aspen Publishers, 2013), p. 129-32. Of course, in this case, the designation of a beneficiary as trustee, a key recommendation of this article, would not be possible.

8 The failure to take this into account is aptly demonstrated by Judge Richard Posner's discussion of clauses depriving a child of a share of the decedent's wealth on account of marrying outside the family's faith or violating some other condition. The problem with inflexible Dead Hand control is that there is no opportunity for "recontracting." See Posner, *Economic Analysis of Law, 7th Ed.* (Aspen Publishers, 2007), section 18.7. However, a powerful tool for assuring the ability to "recontract" is the special power of appointment, exercisable at each generation level. See *infra* text accompanying note 27 for a discussion of this flexibility.

9 The property transferred in trust is the trust's property, not the beneficiary's wealth.

10 An example is the generation-skipping dynasty trust. See Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," 77 Colum. L. Rev. 161, 205-06 (1977).

decedent's death. The question is, then, can the trust fulfill the client's post-mortem wish list in a superior manner? The authors' conclusion is an emphatic YES!

When the alternative is outright disposition, the trust is almost always better suited to achieve the client's goals.

Managerial control. To one degree or another, the client wishes a beneficiary to have control over an inheritance unless giving control is undesirable based on the beneficiary's profile. In addition, the beneficiary will not be happy unless he or she is given reasonable control at proper maturity. For many clients, the natural impulse is to transfer assets outright once the client is no longer alive or no longer needs to have access to his or her wealth, or to provide for outright distributions once the beneficiary reaches a certain age.[11] The instrument of choice for transferring this unfettered control is plainly the "simple will."[12] The simple will cannot assure distributions at various ages; at a minimum, a testamentary trust is needed. However, the authors argue that "control" requires an even more nuanced response, if the interests of the immediate and subsequent generations are to be properly served.

A faulty premise often taken as a given is that a trust cannot afford the same level of control to a beneficiary as can outright ownership. A more sophisticated analysis reveals the flaw in this belief. For example, the primary beneficiary, ordinarily a child of the client, can serve as a trustee or as a co-trustee. As trustee, the beneficiary can be afforded broad discretion in making investments and in exercising indirect control as to distributions. Upon the death of the primary beneficiary, a successor primary beneficiary or beneficiaries can assume the role of successor trustee. In most circumstances, tax planning[13]

[11] A typical example is to distribute one-third of the trust assets to the beneficiary at age 25, one-third of the balance at age 30, and the remainder at age 35.

[12] Alternatively, it could be a revocable trust established during the lifetime of the client and which is unfunded, partially funded, or totally funded during the client's lifetime. The revocable trust could provide, just as the will provides, that upon the death of the settlor, the trust estate is to be distributed outright to the indicated beneficiaries. References in this article to the "simple will" should also be understood to reference this "will substitute."

[13] If the beneficiary is likely to have a taxable estate, after taking into account lifetime adjusted taxable gifts, unlimited discretion to access the trust estate could be regarded as a general power of appointment. This would result in an inclusion in the beneficiary's gross estate under Section 2041. The argument has been made that, as trustee, the beneficiary would have to act impartially. Therefore, there would be a sufficient restraint on the exercise of discretion so as to avoid inclusion in the beneficiary's gross estate. Nevertheless, unless state law explicitly bars distributions by the trustee to himself or herself, the relevant authorities make clear that the discretionary trustee-beneficiary is deemed to have a general power of appointment. See Rev. Rul. 54-153, 1954-1 CB 185; Maytag, 493 F. 2d 995, 33 AFTR2d 74-1454 (CA-10, 1974); Sheedy, 691 F. Supp. 1187, 63 AFTR 2d 89-1531 (DC Wis., 1988).

[14] Use of a limiting ascertainable standard, while helpful for tax purposes, may not work for purposes of protecting the beneficiary from creditors. Creditors could reach the trust estate to the extent that the trustee could exercise discretion for his or her own benefit. The limiting ascertainable standard might not be taken into account. See Restatement (Third) of Trusts, section 60 cmts. a. and g. The Uniform Trust Code section 504(e) addresses the matter by changing this common law rule. Creditors can reach the assets only to the same very limited extent they could if the beneficiary was not also the trustee. The use of an ascertainable standard does not affect the result. See Uniform Trust Code section 504(e). In states that follow the common law rule, the power to make discretionary distributions, along with the delimiting ascertainable standard, could be toggled on and off depending on whether or not there were judgments on the horizon against the trustee-beneficiary. See Horn, "Flexible Trusts and Estates for Uncertain Times," Estate Planning in Depth, SN070 ALI-ABA 315, 334-42 (6/15-20/08).

[15] Even if the co-trustees share distributional authority, it will suffice to protect the beneficiary's interests from creditors. Restatement (Third) of Trusts, section 60 cmt. g. However, this would not be the case for estate tax unless the trustees were adverse. See Section 2041(b)(1)(C)(ii). One solution to the estate tax problem is for the trustee-beneficiary to be given discretionary power over distributions, but only those permitted under an ascertainable standard.

[16] This principle was established in Estate of Wall, 101 TC 300 (1993). See also Rev. Rul. 95-58, 1995-2 CB 191, *modifying* Rev. Rul. 79-353, 1979-2 CB 325 and Rev. Rul. 81-51, 1981-1 CB 458, adopting the view of Estate of Wall, and Estate of Vak, 973 F.2d 1409, 70 AFTR2d 92-6239 (CA-8, 1992), *rev'g* TCM 1991-503. However, the position of the IRS is that, for a provision allowing a substitution of trustees not to have adverse consequences for the beneficiary, the provision must require that any newly appointed trustee not be related or subordinate to the beneficiary as defined in Section 672(c). See Rev. Rul. 95-58, 1995-2 CB 191.

[17] A beneficiary with a special power of appointment is not exposed to estate tax in that beneficiary's gross estate. See Section 2041.

[18] Full use and enjoyment in this context is the maximum use and control permitted by law, while still preserving the tax and creditor protections. Properly designed and implemented, it is the functional equivalent of outright ownership.

[19] For example, what if the children are under age at the time of transfer? Or what if the children are of majority age, but still not at a point in life at which their stability and sophistication has been established? Finally, what if a child is generally responsible, but is married to someone the parents consider controlling?

[20] See, e.g., Uniform Trust Code section 505(2).

[21] As long as a creditor of any sort can reach the trust estate, the portion that can be reached is regarded as retained by the settlor-discretionary beneficiary and subject to inclusion in the gross estate of the settlor-discretionary beneficiary. See Poker, "Asset Protection Planning," Estate Planning in Depth, SU036 ALI-ABA 771, 805 (6/23-28/13)... "Estate inclusion could not be avoided under these statutes [self-settled trust legislation] if the ability of any creditor to reach trust assets under any circumstances at any time caused inclusion under IRC § 2036. In addition, even if one adopts a narrower reading of the authorities under IRC § 2036, it is still unclear whether the asset protection will succeed under the applicable statutes. In such a case, one cannot be certain that estate tax inclusion will be avoided."

and creditor sheltering[14] are improved when certain controls are given to an independent co-trustee, who has sole authority over discretionary distributions.[15] However, this should not be taken as a surrender of control. In particular, the beneficiary serving as co-trustee can retain the power to replace the "independent" trustee with another "independent" trustee.[16] Practically, if not legally, this reposes total control over discretionary distributions in the trustee-beneficiary. This practical power can be given without exposing the trustee-beneficiary's inheritance to the aforementioned predators, as would be the case if the inheritance were owned outright.

Theoretically, as a fiduciary, the beneficiary-trustee owes an obligation to other beneficiaries. Their beneficial rights in the trust estate and the fiduciary duty the trustee owes them inevitably constrain the primary beneficiary's unfettered exercise of control. Yet, unfettered control would expose the trust assets to creditors and the taxing authorities. Reduced, but adequate, control will shelter the trust assets without reducing their beneficial enjoyment. The primary beneficiary still has flexibility by affording the primary beneficiary, in his or her individual capacity, a special power of appointment.[17] The awareness of the secondary beneficiaries that the primary beneficiary can exercise that special power in a manner deleterious to their interests, and without the constraints of fiduciary duty, should indirectly leave the primary beneficiary in full, uncontested control. In the words of Professor Edward Halbach, "[a] power of appointment is also a power of disappointment."

Use and enjoyment of trust assets. Full use and enjoyment[18] can be given to the intended beneficiary who is capable, a person one would pass the wealth to outright if it was not for the many benefits of trusts. Not all potential beneficiaries have equal needs, even when the product of the same parents, the same environment, and the same upbringing. The fact is, some, if not all, of the potential beneficiaries may be incapable, disabled, spoiled, immature, profligate, easily manipulated, ill-informed, or even disinterested. Furthermore, at the time of transfer, it may not be possible to know who will have which traits.[19] In fact, over time, particular beneficiaries may display mixed tendencies toward responsibility or irresponsibility. Sometimes, beneficiaries may become wealthy in their own right and will not need the client's wealth.

Short of special situations, such as an incapacitated child, a parent is likely to hope for the best and be inclined to go "outright." There may be strong pressure from the child, or the child's spouse, to do so. Nonetheless, even with respect to the most responsible of children, there may be forces at work beyond a child's control, such as divorce, that can threaten to divert a sizeable portion out of the family line in the future. It is true that, once received outright, the beneficiary could transfer his or her inheritance to a self-settled spendthrift or discretionary trust in an effort to protect the assets against future claimants. However, once the beneficiary receives, or has a right to the property, he or she is unable to obtain the benefits, protections, and controls that would have been available had the transfer been simply placed in trust by the donor or testator. Self-settled trusts do not afford protection from creditors[20] or from death taxes,[21] unless administered in one of the few states that afford protection from creditors to the settlor of such trust.[22] In fact, the process of creating and administering an effective, defensible, self-settled discretionary or spendthrift trust might in fact, be more complicated and less likely to yield the sought-after protections, than a preexisting trust created by a parent.[23]

A nuanced approach is not possible with a simple will that makes outright dispositions.

Furthermore, distinctions in access between certain "responsible" children receiving their shares outright and other ones receiving shares in trust is almost guaranteed to foster serious resentments that can fuel the disintegration of family ties once the parents are gone. This is precisely the opposite of what the parents want. These distinctions in access can be ameliorated if all children receive their shares in trust as beneficiaries. As to the finer distinctions, in terms of control by the beneficiary over the

[22] The states that have adopted asset protection legislation include: Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, Wyoming, and Colorado (although it is unclear whether the Colorado statute actually offers protection). Of these, the leading states are Nevada, South Dakota, Ohio, Tennessee, Alaska, Delaware, and Wyoming. See Oshins, 4th Annual Domestic Asset Protection Trust State Rankings Chart (Updated) (July 2013), available at www.oshins.com/images/DAPT_Rankings.pdf.

[23] See, e.g., Poker, *supra* note 21, at 792-805.

beneficial interest, these will be less apparent, especially if the trust instrument contains limitations on wholesale access to information by all beneficiaries.[24]

A nuanced approach is not possible with a simple will that makes outright dispositions. In contrast, a trust can be tailored in any way necessary to assure gradations of use and enjoyment by differentiating distinct lines of descendants. Specifically, the trust can be subdivided by incorporating "per stirpes" language by which each family branch is controlled and administered according to the profile of the members of that family branch.[25] Thus, controls, uses, investments, trustees, distributions, and advisors can differ according to the needs, wants, and maturity of the members of each family unit.

The use of a trust clearly furthers the objective of doing what is "best" for the client's descendants. The initial perspective of a potential beneficiary, however, will often be that he or she should have *unrestricted* ownership of the inheritance (unless the desires are to restrict), remembering that the most common alternative is to distribute outright. Nonetheless, once properly advised, the beneficiary, too, should appreciate the risks associated with outright ownership. At least with respect to the primary beneficiary serving as trustee or co-trustee, there will be access to the trust estate as necessary. There is no material difference from outright ownership as far as access is concerned as long as the beneficiary can control the identity of the trustees. On the other hand, there is a world of difference in terms of vulnerability to claimants. Through equitable[26] ownership through a trust wrapper, the assets can be sheltered from the reach of a divorcing or divorced spouse, general creditors, and the taxing authorities, all of whom may otherwise have some cognizable claim on the beneficiary's individual wealth. When properly explained, the beneficiary, too, should welcome the wrapping of his or her inheritance in a trust structure.

Flexibility. A serious deficiency in the use of a simple will is that, once a distribution is made, the plan is set in stone. For reasons already stated,

24 The extent to which a trustee must provide information to the beneficiaries and the nature of that information differs significantly at present from one state to another. Under Uniform Probate Code section 7-303(b), the trustee is required, upon request, to provide a beneficiary only "with a copy of the terms of the trust which describe or affect *his* interest…"(emphasis added). Under Uniform Trust Code section 813(b) Comment, the beneficiary could compel "the trustee to furnish the beneficiary with a complete copy of the trust instrument and not merely with those portions the trustee deems relevant to the beneficiary's interest." See also Fletcher v. Fletcher, 480 S.E. 2d 488 (Va., 1987). Nevertheless, since 2004, Uniform Trust Code section 105(b)(8)-(9), which makes disclosure of certain information under the section 813(b) rule mandatory, has been made optional. Thus, numerous states, that otherwise have adopted the Uniform Trust Code, allow the trust instrument to override the requirements of section 813(b). See, e.g., Tenn. Ann. § 35-15-813(e), for a far-reaching provision that could keep the beneficiary almost entirely in the dark.

25 A per stirpes approach divides up the trust upon the death of the client and/or the client's spouse based on the number of children surviving and deceased children survived by descendants. There are alternatives to this traditional per stirpes approach. However, this option generally reflects what most simple wills provide. For example, a parent has three children and intends to divide his or her assets equally among the three children. If one of the children predeceases the parent, and is survived by children, the parent's estate is still divided into three shares, with one share being for the benefit of the children of the deceased child.

26 "Legal title" is in the trustee as opposed to equitable ownership, which is a right to enjoy trust assets, but not own them.

27 As discussed above, a beneficiary with a special power of appointment is not exposed to estate tax on the assets in the trust. See *supra* note 17 and accompanying text. As for when a power is a general power rather than a special power, see *infra* note 53 and the text accompanying note 64.

28 See *supra* text accompanying note 5.

29 The rate was approximately 3.6 per 1,000 in 2011, whereas the marriage rate was 6.8 per 1,000. See CDC, National Marriage and Divorce Rate Trends (2012) at /www.cdc.gov/nchs/nvss/marriage_divorce_tables.htm. The relationship between the divorce and marriage statistics is complex and has often been exaggerated by false claims, such as that more than 50% of all marriages end in divorce. Still, there are a substantial number of divorces, so that a risk exists that simply cannot be ignored. See, e.g., U.S. Census, Statistical Abstract of the United States: 2012, Table 131: Percent of First Marriages Reaching Stated Anniversary by Sex and Year of Marriage: 2009 at www.census.gov/compendia/statab/2012/tables/12s0131.pdf.

30 Section 2010 effectively exempts a taxable estate of $5 million (indexed for inflation). In the case of a married couple this means $10 million, especially taking into account the ability of the surviving spouse to use the unused portion of the predeceasing spouse's unified credit under Section 2010(c), without even having to balance property ownership between them. However, the actual mechanics of this portability via the deceased spouse's unused exemption, can be daunting, as can the "subtleties of the new paradigm of a $5 million plus exemption equivalent and portability." Golden, "Back to the Future—The Marital Deduction from Before ERTA to After ATRA," Estate Planning in Depth, SU036 ALI-ABA 87, 111-17 (6/23-28/13).

31 For instance, President Obama's 2014 budget proposals, released on 4/10/13, would restrict the duration of the GST exemption to 90 years. The Treasury explanations provide that, "on the 90th anniversary of the creation of a trust, the GST exclusion allocated to the trust would terminate…by increasing the inclusion ratio of the trust (as defined in section 2642) to one, thereby rendering no part of the trust exempt from GST tax." See Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals" (April. 2014), pp. 143-44. However, this particular proposal is not likely to be enacted in the near term.

32 See Schoenblum, *2014 Multistate Guide to Estate Planning*, (CCH, 2013), Table 14.

33 For example, a 6% tax on $1 million requires a payment of $60,000. Had that $60,000 not been taxed and instead had been invested at 3% after income tax, it would double in 25 years. If it were free to accumulate at the same after-tax rate over the course of 100 years, it would equal $1,119,532. By increasing the return to 4%, the appreciated value would be $2,913,747 and, at 5%, $7,514,358.

however, changes in circumstances require flexibility over time. Attitudes commonly change in tandem with the altered circumstances of the client's descendants and the demands of the outside world, notably taxes, but also changes in the economy, lifestyles, and family situations. The trust affords a means whereby these circumstances can be taken into account and appropriate alterations made in the control, distributional, and investment aspects of the estate plan. Change can be effected without tax penalty and by the very beneficiaries whose lives are being affected. Indeed, the trust is the most efficient, flexible, protective, and adaptable means for long-term private wealth management available.

Because flexibility to accommodate the unknown is a primary objective, the governing instrument should incorporate provisions that enable modification over time, while still preserving tax and asset protection benefits. This can best be achieved by granting "special powers of appointment"[27] to the primary beneficiary to essentially "re-write" the disposition. The primary beneficiary, as donee of the power, can be empowered to alter the timing of distributions or even the identities of the other beneficiaries, just like he or she could have done if the property was owned outright, provided that this latitude is not granted in the form of a general power of appointment. This authority to restructure controls, distribution, and investment policy can be passed down to the primary beneficiary at each succeeding generation, thus overcoming perhaps the greatest concern regarding dynastic trusts—their ability over an extended period to adjust to changing or unforeseen circumstances.

Creditor protection. The moment a portion of the estate is received outright by a beneficiary, there will be no protection, presently or in the future, against the claims of that beneficiary's creditors, hungry to devour the inheritance. Had the property still belonged to the decedent, the assets would have been untouchable. This protective environment is replicated by the trust, which essentially replaces the parent in retaining legal ownership, whereas use and enjoyment of wealth is available unfettered in the case of the responsible beneficiary and only under propitious circumstances in the case of the less trustworthy beneficiary.

As has been previously mentioned,[28] claimants can emerge without prior notice. Even a thoroughly responsible beneficiary can fall victim. While the divorce rate is not as high as sometimes advertised,[29] it is still a real risk with liability for spousal maintenance and division of property not contingent upon "fault," and often turning on a judge's or jury's whim. Likewise, professional malpractice litigation is out of control in many states. The responsible child who becomes a successful professional may not only watch helplessly as his or her assets are depleted or eliminated, but may also be deprived of assets inherited outright from parents. The same unfortunate fate might await the child who is a successful entrepreneur, as a result of a business site injury that insurance may not cover. The insurance may be insufficient, or the insurer may balk and call into question coverage. By employing a trust, the inheritance for a beneficiary, regardless of profile, is preserved, entirely insulated from claimants of all stripes.

Tax savings. For many estates, as of 2013, federal estate taxes are not presently a concern.[30] Nevertheless, a longer view is in order. The law may change in the future, affording less shelter. The recent history of the estate tax should not instill confidence as to the current law's permanence. A third certainty, "tax reform," has been added to the two theoretical certainties, "death" and "taxes."[31] Thus, it is foolish to believe that at each generational level the extensive shelter currently afforded will continue to be available. Moreover, even apart from the federal estate tax, a number of states impose their own estate tax or inheritance tax, and even generation-skipping transfer tax.[32] Although the maximum marginal rates imposed by the states are not as high as the federal estate tax, imposition of transfer tax at each generation level is a real drag on wealth accumulation.[33]

A beneficiary-controlled dynasty trust avoids this problem and is now all the more appealing because of the estate tax exemption limits discussed above that allow contribution to a trust without transfer tax cost. These amounts can appreciate astronomically over time, especially if treated more as a family asset pool than as a source to fund consumption, all the while remaining free of federal and state transfer tax in perpetuity.

In addition to transfer tax, there is the question of income taxation. At the federal level, there has been considerable bracket compression, especially with respect to trusts, with the maximum marginal rate of

39.6% reached at a mere $7,500 of taxable income.[34] However, to the extent that the trustee has discretion to make distributions, the additional income tax cost associated with the use of a complex trust can be reduced and even eliminated.[35] Nonetheless, in many instances, if the beneficiary owned the underlying property outright, the income associated with the property would have incurred the same tax. This might be the case because the beneficiary is already in the highest marginal income tax bracket on account of his or her other income (and a spouse's income if married). The beneficiary might be a minor under age 19, in which case the income is taxable at the parent's maximum marginal rate pursuant to the kiddie tax.[36] Alternatively, the beneficiary might be a student and under the age of 24.[37]

At the state level, income tax must be taken seriously. Numerous states impose considerable tax burdens on top of the federal income tax.[38] This imposition can be especially onerous on capital gains[39] when an entrepreneur goes public or otherwise disposes of low-basis assets that have dramatically appreciated. State income taxes are a repetitive drain that diminishes returns on investment annually in terms of periodic income. One solution to the state income tax drain is to situate the trustee and trust administration in one of the states that does not impose an income tax and to make sure that the jurisdictional bases under the law of the home state for taxing do not apply.[40] While there may be resistance to making the situs of the trust out-of-state, the state income tax benefits that accrue may be significant enough to justify taking this step.[41]

Avoiding complexity. One of the justifications for an outright disposition by a simple will is that it avoids complexity. In one sense, this is true. However, it fails to take account of the complexities in the long-term that are likely to result, creating problems that may prove intractable. The trust-centered planning proposed by this article is only marginally more complex than the simple will, but largely neutralizes the long-term complexities that "simple wills" fail to address. On the other hand, the trust-centered planning proposed is considerably less complex in drafting and administration than the traditional trust format examined later in this article.

[34] Section 1(e); Rev. Proc. 2013-15, 2013-5 I.R.B. 444. This is to be contrasted with married individuals filing jointly, an unmarried individual, or a head of household, with respect to all of which the 39.6% rate does not kick in until taxable income of $250,000. Whereas an individual filing a joint return will owe $58,813 at $250,000 taxable income, a trust will owe $97,357.80 on the same taxable income. Moreover, the additional 3.8% tax under ATRA beginning in 2013 kicks in, in the case of a trust, when undistributed net investment income exceeds $11,950. With respect to the other taxpayers referenced above, it does not kick in until the $450,000 and $400,000 taxable income levels.

[35] The high-income tax bracket trust can make distributions to the low-tax-bracket beneficiary. Of course, this undercuts some of the appeal of accumulation trusts. See U.S. Trust, Tax Alert 2013-02. On balance, though, the drag is likely to be minimal when compared to the benefits.

[36] See Section 1(g)(2)(A)(ii). The kiddie tax imposes the parent's tax rate on unearned income above a certain threshold even if the source of the income was a gift from the grandparents of the income-producing asset. See Section 1(g)(4). But, the first $2,000 of a child's unearned income incurs only $100 in federal income tax, an effective 5% rate.

[37] See Sections 1(g)(2)(A)(ii) and 152(c)(3)(A)(ii).

[38] For example, California's maximum rate of tax is 12.3%, with an additional 1% for taxable income in excess of $1 million, thereby representing the top rate in the nation. See Cal. Rev. & Tax Code §§ 17041, 17043. Other states also impose exacting rates such as New Jersey with a top rate of 8.97% on income in excess of $500,000, while New York State has a top rate of 8.82% on income over $1 million potentially in addition to a New York City top rate of 3.876% on income over $500,000.

[39] Almost all states tax capital gains at the same rate as other income.

[40] See Nenno, "Bases of State Income Taxation of Nongrantor Trusts," (6/4/13),available at www.actec.org/public/Documents/studies/Nenno_state_nongrantor_tax_survey_06_04_13.pdf. See also Schoenblum and Schoenblum, "Using DINGs, NINGs and Other Trusts To Reduce or Eliminate State Income Taxes," 39th Annual Notre Dame Tax & Estate Planning Institute (10/18/13).

[41] If the trust is a directed trust, whereby the out-of-state independent trustee simply holds title and investments are left to the primary beneficiary co-trustee, the out-of-state trustee's fee will be considerably reduced. See Dukeminier and Sitkoff, *supra* note 7, at p. 654 n.106.

[42] The key to proper estate planning, as opposed to business succession planning, is the process of selling the appropriate "standardized tools." See Allen, "Motivating the Business Owner to Act," in ALI-ABA, Estate Planning for the Family Business Owner 3, 9 (3/15/01).

[43] See Caverly, "Drafting Trust Provisions-Is that Abuse or Discretion?," Estate Planning in Depth, ST042 ALI-ABA 277 (6/17-22/12).

[44] This format is either in the form of an independent trustee with dead-hand controls (which is often viewed as reprehensible by the beneficiaries) or instead the beneficiary himself or herself serving as the sole trustee.

[45] See *supra* note 12. This is typical with the only difference among trusts of this genre being the ages when outright distributions are made to the settlor's children.

[46] The Delaware Tax Trap can occur when a non-general power of appointment is exercised to create a general power of appointment. Under Sections 2041(a)(3) and 2514(d), the property subject to the power, to the extent exercised, will be included in the gross estate of the powerholder or be subject to gift tax. See Akers, "Estate Planning: Current Developments and Hot Topics," Estate Planning for the Family Business Owner, CU004 ALI-ABA 217, 273-75 (7/10-12/13). Sometimes the Delaware Tax Trap, in precipitating tax liability, can prove a net benefit. See Blattmachr and Pennell, "Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes," 68 J. Tax. 242 (April 1988).

[47] *See supra* text accompanying note 29.

Drafting approaches

Assume then that the client wisely chooses to use a trust to own assets after death rather than make an outright disposition to the intended beneficiaries. Despite wishing to keep it simple, the client is likely to expect a customized document that addresses what he or she believes are the unique circumstances dictated by his or her wealth, family, and goals. Too much customization may not be a virtue, however.[42] Indeed, the more customized the plan, the more expensive it is, and it can limit flexibility. It is also more prone to error—the process of crafting a personalized trust is rife with the risk of inadvertent errors, oversights, and failure to coordinate fully all of the operational provisions.[43] Moreover, novel provisions are often untested—there will inevitably be uncertainties and ambiguities associated with such clauses. Customization can compromise flexibility and tax planning objectives. In the authors' experience, most custom adjustments actually harm the beneficiaries rather than aid them, while causing unnecessary costs and complexities. In other words, the best trust is the simple trust conceptually—one that, through tried and true clauses, aims to achieve the essence of outright ownership, but with protection against various claimants and future flexibility.

Indeed, there are essentially two basic formats—the traditional, trustee-managed format[44] and the more modern beneficiary-controlled format. These differ dramatically from a conceptual standpoint. The traditional trust format is premised on *pre-specified* beneficiary entitlements under the administration of a third-party trustee who is granted relatively little discretion or on situations in which the beneficiary is the sole trustee. For example, a beneficiary may be entitled to required periodic distributions of net income (often commencing at a specified age), followed at specified ages by distributions of a share of principal and accumulated income. The trust then terminates when the trust estate has been fully distributed outright.[45] The trust is not designed to survive several generations and lacks flexibility. Indeed, a current "hot" planning technique is to decant many of these trusts to correct a design flaw after-the-fact. Had the trust been originally designed properly, decanting would be unnecessary. However, decanting has its limitations and could subject trust assets to the Delaware Tax Trap.[46] Accordingly, the "key" concept at play is to design the trust efficiently and correctly at its inception. Relying on decanting is for existing trusts and not newly created trusts.

The modern trust format is a fully discretionary trust that is irrevocable and, yet, amendable. Broad special powers of appointment are granted to the primary beneficiary and subsequent primary beneficiaries for the purpose of rewriting the trust over time. The trust is essentially controlled by the beneficiary, but with certain safeguards to assure that no one can successfully attack the trust. The trust's administration is ideally situated in a "trust-friendly" jurisdiction, i.e., a jurisdiction the laws of which are particularly biased in favor of asset protection, have no rule against perpetuities or have an extended statutory period, and assure certain freedom from state income taxation. Most importantly, the assets are made available for the beneficiary as needed for use and enjoyment. Because there are not any beneficiary entitlements, there is nothing a claimant can access if proper situs is obtained. The independent trustee can "give" or "not give" based on fiduciary and factual constraints.

When the specifics of the traditional and modern formats are compared, the striking advantages of the modern format become apparent.

The problematic features of the traditional approach. The first troubling aspect of the traditional approach is that it exposes beneficiaries down the line to repetitive transfer taxation. For reasons previously stated,[47] this may no longer be a problem for many clients and their families, although it remains one for families when one or more of the beneficiaries already enjoy significant wealth of their own or, based on their talents or investments, are likely to be in that situation in the future. For example, the beneficiary could practice in an area with potential for substantial, periodic earnings leading to a large capital accumulation overtime. A beneficiary may become an investor or entrepreneur involved in a business that could blossom into a mega-enterprise. As previously noted, although the current applicable credit amount and reduced maximum marginal rate of the federal estate tax have been described as "permanent," few serious observers believe that "permanent" means "forever." And there will always be state death tax and state income tax concerns. Discretionary pay-outs permit adjustments as the law and tax rates continue to evolve. It is impossible to project what is "best" without a crystal ball to show what will occur in the future.

There is also the concern about future creditors. Required distributions of income and principal on the basis of a prescheduled plan puts more in the hands of the beneficiaries, even when not needed, and exposes the distributed assets to the beneficiaries' creditors. Indeed, there is an increasing body of law enabling general creditors, divorcing spouses, and tort creditors to step into the shoes of the beneficiary unless the trust is properly crafted.[48]

A perennial problem encountered when using the traditional format is how to provide access to the assets for a key beneficiary, when, for example, the trust's income is insufficient.[49] One solution is the "5 or 5" power of withdrawal.[50] Its use, however, can result in unsatisfactory income tax consequences[51] and raises complex and unsettled gift and estate tax problems, especially since compliance involves rather arcane paperwork requirements. Those who have had the "pleasure" of addressing "5 or 5" powers in the context of premium payment issues associated with irrevocable life insurance trusts can readily appreciate this.[52]

A typical solution to the problem is to make corpus available through reliance on a HEMS ascertainable standard.[53] The beneficiary may be entitled to a distribution because of health, education, maintenance or support needs.[54] The standard can be drafted to allow maintenance at

[48] See Langa, "Converting Asset Protection to Asset Collection: A Creditor's Perspective," 39th Annual Notre Dame Tax & Estate Planning Institute (10/18/13).

[49] With the decline of returns on investment, a beneficiary whose only access to the trust is the mandatory right to net income, may feel hard-pressed. For example, a $3 million trust corpus may yield an annual pay-out to the beneficiary of only $60,000, a net return of 2%. This would be especially the case if the trust instrument imposes limitations, common in the case of the traditional format, with respect to permissible trust investments.

[50] The "5 or 5" power is set forth in Section 2514(e). To the extent of the greater of $5,000 or 5% of the fair market value of the trust corpus, there will be no gift if the person who has the power to withdraw property from the trust allows that power to lapse. Thus, in years in which the power is not exercised and the property remains in trust, it will not be deemed to have been given as a gift by the donee of the power to the beneficiaries of the trust. Were the withdrawal right a greater amount, the excess could result in gift tax or at least depletion of the unified credit.

[51] Ltr. Rul. 9034004, 8/24/90. This private letter ruling holds that a person who has a "5 or 5" power is deemed the owner of a portion of the trust for income tax purposes and therefore must report income with respect to the portion of the trust estate associated with the withdrawal right. Upon the failure to exercise the power, it will be deemed a release, equivalent to an exercise, and, thus, as if the donee received the income. During each succeeding year in which the power is not exercised, the donee will be treated as the owner of an increasing portion of corpus of the trust and taxed on the income attributable to such corpus.

[52] For a detailed discussion of the various requirements, see Katzenstein and Sellers, "Giving Crummey Notices: Best Practices," 150 Trusts & Estates 20 (August 2011).

[53] The standard is derived from Section 2041(b)(1)(A), which provides that a "power to consume, invade, or appropriate property for the benefit of the decedent which is limited by an ascertainable standard relating to the [H]ealth, [E]ducation, [S]upport, or [M]aintenance of the decedent shall not be deemed a general power of appointment." (Emphasis added.) By using the standard, a beneficiary who dies with an invasion power limited by the standard will not have the property subject to the power included in the deceased beneficiary's gross estate. Such a limited power is commonly referred to as a "special power of appointment." A power is also a special power of appointment if the donee cannot exercise it in favor of himself, his estate, his creditors, or the creditors of his estate. Section 2041(b)(1). Certain powers exercisable only in conjunction with another person may not be deemed a general power. Section 2041(b)(1)(C). Only general powers of appointment will cause trust assets to be included in the gross estate of a beneficiary.

[54] The standard need not be at a minimal level of support, for example, but instead be at any higher level specified. Furthermore, there is no requirement that other resources of the beneficiary need be taken into account, although this should be specified in light of the objective.

[55] A beneficiary can require the trustee to make such distributions even if the trustee refuses to do so.

[56] That litigation can be intense and prove costly even to knowledgeable and well-motivated fiduciaries. For example, in many jurisdictions the law is not clear, if the matter is not addressed in the instrument, whether other resources of the beneficiary may be taken into account and whether the trustee has a duty to inquire into the beneficiary's situation. See, e.g., Marsman v. Nasca, 573 N.E. 2d 1025 (Mass. App. 1991). Apart from these questions, there is the more practical drafting question as to whether or not other resources *should* be taken into account. For an excellent consideration of this and other drafting issues relating to a discretionary distribution right limited by an ascertainable standard, see Horn, *supra* note 14.

[57] See *supra* note 14.

[58] While technically the beneficiary serving as sole trustee is granted the same protections from creditors as a third party trustee, this is only so long as Uniform Trust Code section 504(e) applies. In a Uniform Trust Code state, then, it may be possible to dispense with an independent co-trustee altogether, so long as the standards governing distributionis drafted precisely and is not so broad as to require payments for spousal or child support under the standard. Of course, the narrower the standard is drawn, the less access the beneficiary will have. Moreover, regardless of the standard, a spouse or child may very well have a claim under the Uniform Trust Code. Under the common law, there may be even less protection. See Restatement (Third) of Trusts section 60, cmts. a. and g. Indeed, the trend is to reduce the previously-impervious-to-attack "spendthrift" protections. Accordingly, the authors strongly recommend the use of the independent trustee.

[59] The revocable trust asset is deemed owned by and under the control of the settlor as long as the settlor has a power to revoke that is exercisable over the property. When the property is formally distributed by the trustee to a beneficiary other than the settlor, that ownership and control has been surrendered, a transfer has taken place, and, therefore, a taxable gift is generated. However, when the trustee of an irrevocable trust makes a distribution to a beneficiary, the property has already been put beyond the settlor's control via a taxable transfer and the beneficiary is deemed to have beneficial ownership. Thus, there is no basis for finding that a second taxable transfer has occurred. In many instances, by making the transfer to the trustee of the irrevocable trust early on, subsequent appreciation of the transferred assets is removed from the transferor's gross estate.

[60] This will turn on which law governs the trust with respect to the question of perpetuities. See generally Sitkoff and Schanzenbach, "Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes," 115 Yale L.J. 356 (2005).

a certain station in life, rather than a minimal level. Also, other resources of the beneficiary need not be taken into account. In some traditional trusts, this standard is mandatory.[55] In others it is mixed with a grant of trustee discretion. Considerable caution must be exercised in drafting the standard to avoid many interpretive issues and to assure the intended access. Otherwise, the use of an ascertainable standard can be a prescription for litigation between the trustee and the beneficiary[56] as to its scope or as a backdoor basis for the assertion of creditor and other claimant claims.[57]

There is a real conundrum in drafting the HEMS standard or even whether to use it. A common goal is to assure distributions for the "support" of the beneficiary in the style to which he or she is accustomed. Depending on applicable law and judicial interpretation, which is not always predictable, creditors may be able to gain access because of the 'support' they are providing. A purely discretionary trust, without HEMS, has a much better chance of insulating the trust assets from the creditors' reach. However, this has a perceived drawback. It puts a third party, as an independent trustee, in control. Nevertheless, giving the primary beneficiary the right to remove and replace the independent trustee will give the primary beneficiary indirect control once he or she understands the simplicity of firing the independent trustee and the broad range of available replacement trustees.

The modern beneficiary-controlled trust format. How does the modern trust format address these issues and deliver on the client's wish list? To begin with, a beneficiary can have more "control" than the creator of a trust. Effectively, a responsible beneficiary is given "full control," that is, the maximum control permitted without exposing the beneficiary to the federal estate tax and other potential claimants. As for the less responsible beneficiaries, control can be calibrated to take account of the known deficiencies associated with, at least, existing beneficiaries. There are several types of control—administrative, use and enjoyment, and dispositive. These aspects of control are always subject to modification by the primary beneficiary through a special power of appointment so that an incapable, irresponsible, contentious, or unneedy beneficiary can be reined in. To replicate the "outright" option, the trust separates into shares for each branch of the family, with separate subtrusts being established on a per stirpes basis. Within each subtrust, a primary beneficiary can be a co-trustee along with an independent co-trustee of his or her choice. The family co-trustee controls business and investment decisions. More importantly, the family co-trustee controls the identity of the independent trustee because the independent trustee is subject to removal and replacement by the family trustee, as long as another successor independent trustee is appointed.

The independent co-trustee formally controls all tax and creditor-sensitive decisions. The beneficiary, however, practically controls them because the beneficiary is free to replace the independent co-trustee.[58] No HEMS or other ascertainable standard is needed or used, due to the legal and tax issues previously discussed. Because the independent trustee has total discretion, even a spouse's and child's support claim need not be honored, at least where the traditional common law reigns. This is also true under the Uniform Trust Code, because the trustee cannot be required to distribute more than is required, as long as the trustee is not abusing its discretion.

As for distributions, they are not scheduled as in the case of the traditional format. Rather, they are made available on a use-and-enjoyment basis in the best interest of the beneficiaries. There are no pre-selected mandatory distribution points in time with respect to either income or principal. By keeping the assets in the trust wrapper, they are insulated from "predators" and control is maintained. Indeed, the "use" trust is similar to the commonplace standard revocable trust. However, unlike that genus of trust, there need be no concern about taxable gratuitous transfers upon distribution.[59] Unlike the traditional trust format, the "use" trust can be long-term and has the potential to last forever.[60] Indeed, excessive distributions under the modern trust format are discouraged, unless there is an income tax savings or other compelling reason to make them. When distributions are made, they are primarily for support and consumption purposes, so that there is no property outside the trust wrapper, which would then be exposed to the predators identified earlier. For example, a beneficiary can even be granted the rent-free use of the family vacation home. Rent-free use of an asset in a beneficiary-controlled trust is the functional equivalent of personal ownership without the exposure to claimants that ownership entails.

The trust is recycled from generation to generation, subject to amendment by the special power of appointment. By creating separate, per stirpes dynasty trusts, sibling conflict is avoided. Controls can be varied from trust to trust. Each separate trust can have different trustees, investments, and advisors, and distributions can be made according to the needs of each family line and its particular members.

The modern trust format permits wealth administration in coordination with assets of the primary beneficiary outside of trust. Thus, there is the possibility of opportunity shifting.[61] While wealth accumulates and grows in the trust, the primary beneficiary's personal estate depletes. That is, wealth outside the trust wrapper is spent on wasting assets and consumables. This approach reduces exposure to transfer tax as well as to claimants.[62]

An income tax issue that typically arises with respect to real estate and other appreciated assets is how to handle the disposition of low or negative basis properties. If the assets are placed in an irrevocable trust during the owner's lifetime, the step-up in basis is sacrificed at death. This argument is sometimes urged as a reason for making an outright devise at death or maintaining the real property in a revocable trust until death.

However, the step-up problem arises only when the transfer into trust is occurring during the lifetime of the owner. There is a step-up for a transfer to the trustee of a testamentary trust. The step-up in basis at death is not obtainable if an outright gift of the real estate or other appreciated assets is made to an irrevocable trust, because, under Section 1015, there is no step-up in the case of a gift.

Notwithstanding the foregoing, there may not be a need for a step-up in basis in the future. A classic example would be a family vacation home. If the intention is to retain the vacation home in the family well beyond the settlor's generation, there will not be a disposition to a third party and thus there will not be an income tax in the foreseeable and not so foreseeable future. Second, if the asset is real property, there may be an interest in maintaining it as part of a diversified trust portfolio. Moreover, the trust need not be stuck with the same real estate. Due to the like-kind exchange provisions of Section 1031, there are a broad set of alternative interests classified as real estate that could be acquired upon the sale of the existing real estate without any tax cost. Meanwhile, the quality of the real estate investment can be enhanced via successive sales and reinvestments. Third, the basis issue can be solved, at least in part, by the settlor's retention of a general power of appointment with respect to the real estate, to the extent of any remaining unified credit. Alternatively, an independent trustee could be given the authority to grant a beneficiary a general power of appointment, which can be limited to assets with built-in gain. This can be a co-power with another person to assure the proper exercise. Upon the death of the beneficiary, the result will be a step-up in basis.[63]

Finally, it must always be recognized that any capital gain will be taxed at only a maximum 20% or 25% rate.[64] On the other hand, the net value will be taxed under the transfer tax at a maximum 40% rate at death. To the extent a grantor trust purchases the real estate or other assets, there is no gift and any taxable gift issues are sidestepped. True, retention of the property until death to obtain the step-up is not available. However, the asset can be repurchased by the settlor from the trust if obtaining a step-up in basis would afford more tax savings than the estate tax cost and other non-tax considerations are not dominant.

In addition, much wealth can be created by use of life insurance purchased by the trust on the life of a beneficiary, using existing trust assets to pay the premiums. Thus, limitations on making gifts are avoided, which eliminates complexities of premium payment by the insured and the need for *Crummey* demand powers. In addition to providing traditional life insurance coverage for the beneficiaries, the "inside" buildup is income tax-free.

Generation-skipping transfer tax planning is also essential as there may very well be a skip generation even if a dynasty trust is not in-

[61] For an extensive discussion of the use of opportunity shifting and its substantial benefits, see Oshins & Oshins, *supra* note 7.

[62] With divorce, if property is inherited, it may not be reachable by the ex-spouse anyway, depending on the applicable controlling state law and whether such property is commingled with marital assets. See Landers, "How Assets Get Divided In Divorce," Forbes.com (4/12/11), www.forbes.com/sites/jefflanders/2011/04/12/understanding-how-assets-get-divided-in-divorce/.

[63] The introduction of a non-adverse co-holder of the power will not shield it from inclusion in the gross estate of the beneficiary. Thus, a careful cost-benefit analysis will have to be undertaken before the independent trustee grants such power. *See* Breitstone and Hesch, "Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution," 53 BNA Tax Management Memorandum 311 (August 2012).

[64] Unrecaptured Section 1250 gain is a 25% capital gain (Section 1(h)).

[65] See Sections 2503(e) and 2611(b)(1).

tended. There ordinarily is a non-exempt GST trust and an exempt GST trust. The non-exempt GST trust can make distributions to non-skip persons. If there is a need for medical and educational payments to skip persons, the payment of medical and education expenses directly to the provider is not exposed to the GST tax.[65]

A four child example

Assume Senior has four adult children, all of whom she loves equally. However, she acknowledges the very different situations of her children. Alpha is artistically inclined, works in the theater, and earns little income. He lives with a spouse-like companion who also works in the theater and has limited resources. The companion exerts an enormous amount of influence over Alpha and not always for the better. Alpha currently has no children and does not plan on having any in the future.

Beta is pursuing his dream of creating software he hopes will eventually be acquired by a public company at a price in the hundreds of millions of dollars. The client is far from certain whether this is just one more pipedream or whether this time Beta will actually hit it big. To really get things going, Beta will need an infusion of capital from Senior for his newly organized LLC. Beta is married to his third wife.

Gamma is a highly successful anesthesiologist. He has three children and has been married for twenty-five years to a woman whom the client adores. Gamma is doing quite well presently, and has accumulated some wealth of his own, which is primarily in a qualified pension plan. Gamma is concerned, however, about what the future of medical practice holds. This is especially true because he is used to spending a great deal on consumables.

Delta is the ideal outright inheritor. He has wealth, albeit below the estate tax exemption, and is capable, responsible, mature, and not profligate. Delta has climbed his company's corporate ladder to a secure management position in a field that is not prone to risk or personal liability. Meanwhile, he is married to his high school sweetheart with whom he has two children. Indeed, Delta is the child that most clients and attorneys generally advise the following: "Just give it outright!"

A consideration of the foregoing facts reveals that each of the first three children has diverse personal circumstances, but also that each faces dangers with respect to any inheritance. Alpha could prove susceptible to his companion's importuning, especially once Senior is not there to serve as a counterweight. Beta faces an especially problematic estate tax problem if his software takes off. There could be a huge appreciation in his wealth, with a substantial state estate tax in addition to the federal estate tax. Furthermore, in light of his failure rate with prior marriages, there should be skepticism that the present one will continue, and, if the marriage does not, there will be the risk of a support and property division claim from his current spouse. Gamma faces a risk of malpractice or other judgments for damages that could severely diminish or eliminate much of his personal wealth apart from his pension plan, which, under ERISA, is protected from creditors. There is also the danger his earning capacity could be reduced because of changes in the provision of health care. He could eventually live off his pension, but might have to curtail his lifestyle. He would also be expending assets that ought to go to his own children. The availability and preservation of a separate source of inherited wealth is, thus, of critical importance to him. Because her grandchildren are involved, addressing these matters is also vitally important to Senior. Meanwhile, although Delta, the ideal child for an outright inheritance, does not present the same concerns as the other three children, a trust is still the appropriate vehicle for him. If an outright disposition were made, Delta would be deprived of the myriad advantages offered by use of a trust.

Senior's dispositive instrument, most likely a revocable trust agreement, provides that, on her death, the trust estate be divided up into four distinct trusts, one for each child. Each distinct trust would be modeled on a more modern format, but with certain variations. With regard to Alpha, there will be more limited beneficiary control. This is a case in which an independent trustee should make all determinations as to distributions, perhaps without the ability of the beneficiary to replace it. A trust protector could be introduced to oversee the trustee's decisions to assure that the trustee is not being too stringent or lax in upholding

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the distributive standard. Still, the critical concern here will be to insulate the inheritance, so that it is expended reasonably for the benefit of the client's son and kept from the grasp of his companion or creditors. Furthermore, the client wishes that any part of the inheritance remaining at Alpha's death pass to her beloved grandchildren, the descendants of Gamma. This could not be assured with an outright distribution.[66]

With respect to Beta, there are considerable concerns about a spousal claim and the estate tax liability that could accrue if the software proves a success. Indeed, this trust might actually be created while Senior is still alive. Senior would be the settlor. Senior can purchase, at a very low price, the software, put it in an entity in exchange for units, and contribute or sell the units to the trust thereafter at a very low value. If the software takes off, it will be locked into the trust and whatever remains after Beta's death can pass to Senior's grandchildren at no additional transfer tax cost. When the software or the software entity is sold, there will be capital gains. The add-on state income tax may possibly be avoided or at a minimum deferred, by having a co-trustee who administers the trust, particularly distributions, from a tax-free jurisdiction. Beta, of course, will have the power to remove the trustee and replace it with a more pliable institutional trustee, if that becomes necessary.

With regard to Gamma, an independent co-trustee who exercises full discretion with regard to distributions is also necessary. Only in this way can the client be assured that a malpractice or similar judgment will not reach the inheritance held in trust. As long as there are no claims, the trust can serve as a family bank, wherein wealth continues to accumulate for eventual transfer down the line to Senior's grandchildren and younger, subsequent generations of her descendants. Meanwhile, Gamma can fund his routine expenses through his personal assets and largely live day-to-day off his accumulated retirement funds.

With respect to Delta, the ideal child for an outright inheritance, an independent third-party trustee would retain full discretion over distributions. Although Delta does not have current or looming creditor risks, in order to hedge against unforeseen claimants, a fully discretionary trust would still be established. Despite having an independent trustee, Delta would retain the use and enjoyment of trust assets in light of his ability to fire and replace the independent trustee. Further, Delta would retain control over trust assets and the ability to respond to changing tax laws or family dynamics through a special power of appointment, or "rewrite" power. In addition to the foregoing benefits achieved for Delta, the use of a trust, as opposed to an outright distribution, would also save taxes.

Conclusion

This article has emphasized the role an irrevocable trust can play in the management and disposition of a client's wealth upon the client's death even for clients with a net worth that is *not* exposed to estate taxes. Indeed, the focus on federal estate tax considerations must not distract from the potpourri of additional client concerns that can (and should) be addressed via the trust vehicle.

An outright disposition to children or other beneficiaries by will or otherwise is not an adequate response to a client's request to "keep it simple." The client must be apprised of the dangers lurking out there, particularly the "predators" that can consume part or all of the inheritance at some point in the future. In many instances, protections against these predators can be built into the instrument, without eliminating effective control from the beneficiary. Even when certain restraints on control must be introduced to guard against the beneficiary's own irresponsibility or to defeat claims of third parties, this can be accomplished by an independent co-trustee with principal responsibility for distributional decisions, but subject to replacement by the primary beneficiary co-trustee with another "independent" trustee.

The foregoing proposed method of inter and multi-generational wealth management is substantially superior to the traditional trust format, which improves little on the alternative of outright distributions and suffers from many of the same deficiencies. ■

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[66] This transfer potentially can result in generation-skipping transfer tax liability. The trust assets can be allocated between a GST exemption sub-trust and a non-GST exemption sub-trust. The management of these trusts is discussed in Oshins & Oshins, *supra* note 7. Generally, at each generation, expenses would be paid out for beneficiaries from the non-exempt trust, the goal being to continue building value in the tax-exempt trust.