Keeping Assets in Trust

This memorandum explains why I strongly believe that **all** but a small gift or inheritance should be made to one or more trusts for the benefit of your family, instead of giving or leaving assets directly to them.

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BAKER LAW
helping your family and business succeed

This memorandum explains why I strongly believe that ***all*** but a small gift or inheritance should be made to one or more trusts for the benefit of your family, instead of giving or leaving assets directly to them.

- Giver's Perspective: You can enhance the value (and benefits) of gifts and inheritance you give or leave to your family by using trusts.

- Recipient's Perspective: If you expect to receive a gift or inheritance from a parent of another person, you too could enhance the value (and benefits) of your gift or inheritance, by helping your parents or others structure their plans to have such gift or inheritance received by your own specifically drafted trust.

Why Use Trusts? Assets held in a well-designed *third party trust*[1] have the following advantages over an outright inheritance:

1. Asset Protection Features. One of the most valuable features of a third party trust is its asset preservation and protection features, not just protection from creditors, but also protection from demands of others.

(a) Wise Handling of Assets: Sometimes, either through lack of interest or lack of discipline, beneficiaries may not be able to wisely handle large inheritances. As a solution to this problem, assets can be held in trust for the benefit of the beneficiary. With a trusted advisor, bank or trust company serving as a trustee, the assets can be effectively managed.

(b) Creditor Protection: Generally, assets held in a third-party trust are **not** subject to the claims of most creditors[2] of a beneficiary, including an overreaching spouse or former spouse, so long as the trust is a properly drafted "*spendthrift trust*" or a "*fully discretionary trust*" (or both). If the asset management abilities of the beneficiary are not a concern, it is even possible for the beneficiary to be the trustee of his or her own third party trust.

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[1] A "*third party trust*" is a trust in which a grantor, donor or settlor (e.g. the person who transfers assets to the trust) **is not** a beneficiary of a trust. A "*self-settled trust*" is a trust in which a grantor, donor or settlor (e.g. the person who transfers assets to the trust) **is** a beneficiary of the trust.

[2] Certain states allow preferred creditors to get to the trust assets to the maximum extent the Trustee could make distributions to a beneficiary. Such preferred creditors differ from state to state, and often include claims of a beneficiary's child, spouse or former spouse for support claims of those who provided necessities to the beneficiary and claims of a state or the United States.

Observation: A third party trust offers creditor protection for the beneficiary, but in most jurisdictions[3] assets held in a trust you create for yourself (known as a "*self-settled*" trust) will be subject to claims of your creditors.

In today's litigious society, and with the alarming divorce rate, why would anyone *plan* to give or leave assets directly to loved ones, to merely expose them to the perils of a law suit (a "slip & fall" claim, or malpractice claims for professionals, etc.) or claims of a spouse or former spouse?

2. <u>Tax Savings</u>. Trusts can be very valuable vehicles to save or defer income, gift and estate taxes.

(a) <u>Income Taxes</u>. A trust can be designed to distribute its income in equal or unequal shares (referred to as "*sprinkle and spray provisions*") among a class of beneficiaries, such as a child and that child's descendants, or the income can be accumulated and taxed to the trust. If taxable income is distributed to a beneficiary who is in a lower income tax bracket (as compared to the trust or the other beneficiaries), tax savings will be realized.

Example: If you create a trust for a son and his daughter (your grandchild), and if the son's marginal income tax bracket is 35%, and his daughter's bracket is 15%, then a distribution of $10,000 of income to your grandchild, instead of to your child, will save about $2,000 in income taxes.

- Some states do not tax income accumulated in a trust. Unfortunately, Ohio does tax accumulated trust income but it may be possible to change the trust "situs" to a different state that does not tax the accumulated income.

(b) <u>Save Estate Taxes</u>. You can leave your assets to a trust for the benefit of your child and their descendants, and, unless you give the child too much control over the trust assets, the assets will <u>not</u> be taxed in your child's estate at death.

- A generation-skipping transfer tax ("**GST tax**") will be imposed when assets are "transferred" from one generation to another generation that is at least two generations below that of the transferor. For example, if you set up a trust for a child, and after the child's death the assets are payable to (or are held in trust for the benefit of) your grandchildren, a generation-skipping transfer tax will be imposed at the top estate tax rate. Fortunately, each taxpayer has a "*GST exemption*" that will shelter all or a portion

[3] There are several states, such as Delaware, Nevada, and Alaska, and Ohio, to name a few, and some off-shore jurisdictions, such as Cook Island and Nevis, to name a few, that <u>may</u> have creditor protection from *self-settled trusts.*

of his/her assets that may ultimately pass to the grandchildren from the confiscatory GST tax. Once trust assets are "*GST exempt*," they remain exempt forever, and such "exempt assets" will <u>never</u> be subject to transfer taxes again.

- Most trusts should be designed to last for the longest time permitted under law. Under Ohio law, the settlor of a trust may "*elect*" to leave assets in trust literally forever!

(c) <u>Tax Savings of a Long-Term Trust ("Dynasty Trust").</u> For example, over a term of 75 years, $2,000,000 of "GST exempt" assets may grow[4] to over $158,000,000, so long as no gift, estate or GST taxes are paid at each generational level. If, on the other hand, the same $2,000,000 of assets were to pass directly to the members of each of 3 younger generations (i.e. children, grandchildren and great-grandchildren), and if we assume a 50% estate tax will be imposed every 25 years at each generational level, the assets at the end of the 75-year period may be worth only about $34,200,000. ***<u>In this example, the GST Exempt Trust saved over $123,000,000 of taxes over a 75-year period</u>!***

- If a husband and wife each added $2,000,000 to a GST Trust, the savings would double to over $245,000,000!
- The transfer tax savings of making full use of your GST exemptions by using trusts are truly astounding.

(d) <u>Gift Taxes</u>: Leaving assets in trust can be very favorable because distributions can be made to the beneficiaries' gift tax free. For example, if you leave assets directly to a child and later they give money to their child (your grandchild), your child's transfer to your grandchild may be subject to the gift tax. On the other hand, if you set up a trust for your child and their descendants, the Trustee of the trust could make a distribution to any grandchild, and such distribution would <u>not</u> be a gift made by your child. By leaving assets in trust, you will "give" your child a "gift giving vehicle" to enable large sums of money to pass from the child's descendants outside of the *gift* tax system.

3. <u>Beneficiary's (You or Your Child) Perspective: Use and Control of Assets</u>. With all of the benefits of trusts, why would you or your children or any other beneficiary not want gifts or inheritances held in trust?

Observation: Most clients do not use trust for the maximum time allowed because they do not want to restrict the primary beneficiary's use and control over assets, regardless of the potential asset protection and tax saving features of trusts.

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[4] Assumes an annual rate of return (income and growth) of 6% (before income taxes).

However, a well-designed trust can be very flexible and the primary beneficiary can have significant, albeit not unfettered, use of and control over the management of the trust assets. In fact, a properly designed "*Beneficiary-Controlled Trust*" can give the primary beneficiary the **functional equivalent of outright ownership** along with the tax saving benefits of a trust as previously described, and perhaps some level of asset protection.

For example, at death your estate could be divided into separate equal shares, one for each child. Each child's share would be held in a "*Beneficiary Trust.*" Below is a description of the controls that you can give to your child as primary beneficiary of the trust.

(a) Trustee: A child can be the sole "*regular*" Trustee of the Trust (usually upon attaining a certain age of maturity as selected by you, for example age 35). This gives the child **control** over the day-to-day management and investment of the trust assets. A "special" Trustee ("**Independent Trustee**"), who is not your child or a person related (e.g. spouse or family) or subordinate (employee, etc.) to your child, such as a friend of the child, a trust company, an attorney, CPA or other professional, would be appointed to serve as "special" Trustee to exercise certain "*tax & creditor sensitive*" powers.

Observation: Although the favorable tax and creditor protection aspects of third party trusts can be obtained if a beneficiary is also a trustee of the trust, the benefits of these aspects of third party trusts are much more certain when an independent trustee is serving.

(b) Distributions to Primary Beneficiary-Trustee: The child could be the primary beneficiary of his or her Trust, and the child's spouse and children and their issue (and spouses) could also be concurrent, secondary beneficiaries. The child, as Trustee, could be authorized to distribute assets to any beneficiary, including himself or herself, for any beneficiary's ***health, education, maintenance or support*** ("HEMS standard"); provided, no such distribution could be made to a beneficiary if it relieves the child-Trustee of a legal obligation, including support, with respect to the beneficiary. The Beneficiary-Trustee's distribution power subject to the HEMS standard may cause a loss (or partial loss) of the asset protection features of the trust, however, such power will **not** cause the Trust assets to be taxed in the child's estate.

(c) Use of Trust Assets: The Trust could purchase tangible personal property or real property, such as homes, automobiles, boats or artwork, just to name a few, and the child could use, enjoy or occupy such property without paying rent to the trust. Also, the trust could make loans to any beneficiary or invest in any business.

(d) Power to Direct Disposition of Assets: A child could be given power to appoint the trust assets to others (e.g. a power to cause the assets to be distributed to others), *excluding* the child, their creditors, their estate or the creditors of their estate. The *permissible*

appointees could include, for example, the child's spouse, children or their issue, or any charitable organization. In essence, the child could "re-write" the trust to benefit others.

(e) No Estate Taxes on GST Exempt Trust: At the child's death, the assets held in the GST Exempt Trust will not be subject to estate taxes in the child's estate, nor will the GST tax be imposed on such assets. The assets held in the child's *Nonexempt* Trust, if any, will be included in the deceased child's estate, to avoid the confiscatory GST tax, and to perhaps take advantage of the child's unused applicable exclusion amount.

(f) Trusts for Every Generation: At death, if a child does not appoint the assets to others, such assets would be divided into separate equal shares, one for each child of the deceased child. Each grandchild's share could be held in trust, to be administered the same as the predeceased child's trust with each grandchild becoming the primary beneficiary of such trust. Your heirs will "inherit" interests in trust, not assets!

Please avoid making the mistake of not using trusts to hold assets for the benefit of your descendants for the maximum duration permitted under the law. You may want to share a copy of this memorandum with your children to make them aware of advantages of trusts as part of your estate plan. In my experience, after the advantages of trusts are explained to children, they prefer to receive their "inheritance" in a "Beneficiary Controlled Trust," instead of receiving the assets directly. On the other hand, if you believe that a child or more remote descendant should not have the maximum flexibility to control his or her trust assets (perhaps because the child is a "spendthrift" or he or she may be unable or unwilling to manage the trust assets), then we can custom design "safeguards" in the trust, which may be different for each child, to protect and preserve the trust assets.

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