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Reasons Why the Average Individual Should Use Trusts

Many lawyers who have not had experience working with trusts, whether personally or professionally, might question the utility of a trust these days for most individuals who are not "ultra-rich."

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Many lawyers who have not had experience working with trusts, whether personally or professionally, might question the utility of a trust these days for most individuals who are not "ultra-rich." In fact, 20 years ago it appeared that for most clients, trusts were generally only considered worthwhile for three main purposes: (1) protecting "youngish" and somewhat inexperienced children under the age of 35 from wasting away inherited money and having regrets later; (2) funding a "bypass" or "credit shelter" trust to avoid wasting the exemption from federal estate taxes (then $600,000 per spouse); and (3) protecting a widow (but not typically a widower) from potential financial predators.

Things have changed quite a bit since then. These days, we find that most clients like the idea of establishing lifetime trusts for their children (and even grandchildren) under their estate plans, as opposed to the "classic" structure of allowing a child to withdraw the entire trust balance at age 35 (often they now elect to permit the child to be sole trustee at age 35 in lieu of the outright distribution). They also, more often than not, like the idea of creating trusts for either surviving spouse (this appears to be largely attributable to the increasing awareness of the potential for diversion of family assets upon a remarriage by the surviving spouse). There are still significant tax benefits for many individuals (and the objects of their bounty) arising from the creation of trusts, but, undoubtedly, for fewer individuals than was the case 20 years ago given the significantly increased exemption from federal estate tax ($5.25 million per spouse this year) and the new "portability" features for the exemption that allow the surviving spouse to "inherit" the predeceased spouse's unused exemption so that it would not be wasted (although, notably, portability does not apply to the exemption from the generation-skipping transfer tax).

The nontax benefits of a trust for families can be significant. Many clients who value trust structures have worked hard their entire lives to create and preserve wealth that they can pass on to the next generation and it is satisfying for them to know that they have created a structure that will help preserve that wealth, as well as possible, for future generations. Certainly, other clients have different life philosophies, feeling that it is best to let children make their own mistakes. These clients are more comfortable with the notion that it is "their problem" if the children dissipate the wealth they inherit after the clients have passed, but, from our experience, they are in the minority.

Setting aside potential tax benefits, we find that the main attractions to trusts for our clients are threefold: (1) creating a structure for an inheritance that separates the inherited assets from other assets, thereby helping trust beneficiaries preserve the assets on a psychological level (much like an IRA or 401(k) plan account segregates retirement assets from other assets and helps keep them "off-limits" for potential current dissipation); (2) allowing someone other than (or in addition to) the trust beneficiaries to be involved with (or have control over) investing the assets and making decisions about distributions to beneficiaries; and (3) creating an effective legal shield to protect the assets from a beneficiary's creditors, divorcing spouses and surviving spouses.

Trust governance can easily be tailored to fit the precise needs of a client's family. Oftentimes it makes sense for the primary trust beneficiary to serve alone as trustee so they can avoid the complications of joint decisions. However, when the primary beneficiary is not adequately trustworthy — whether because of youth, incapacity, conflicts of interest (such as in the case of a surviving spouse who has children from a prior marriage), or a track record of personal or financial irresponsibility, it is advisable to identify the appropriate family member, friend, professional adviser or financial institution to serve alone, or along with such beneficiary, as trustee. In many cases, the selection of a nonbeneficiary as sole or co-trustee is appealing not necessarily because of a beneficiary's lack of trustworthiness, but rather due to the ability of such trustee to deliver significantly greater investment expertise and financial discipline than could a beneficiary serving alone in that role. Appropriate checks and balances can be built in for the outside trustees by providing beneficiaries (or other trusted third-parties) the power to remove and replace the outside trustees.

The distribution structure of a trust can also be varied. Most (but, of course, not all) trusts use the "ascertainable standards" found in the Internal Revenue Code to govern distributions to trust beneficiaries. Those standards are typically "health, education, support and maintenance." In addition, when a financial institution or independent individual is serving, frequently the trustee is also given the broader flexibility to make additional distributions for any reason. Other common provisions include the power to make distributions for a wedding, to start a business or professional practice, or to buy a home.

A trust can be set up for one current beneficiary, or for multiple current beneficiaries. In Pennsylvania, in order to avoid the imposition of the Pennsylvania inheritance tax on the death of the first spouse to die, a trust must be for the "sole benefit" of the surviving spouse. Prior to that change in the law, it had been more common for a "family trust" to be created on the death of the first spouse to die where the spouse and children of a client were all current beneficiaries of a trust.

Another key design feature is whether to mandate the distribution of all of the trust income each year, or allow it to be accumulated. It used to be very common to require that all trust income be distributed each year. In fact, many older trusts only allowed trust income to be distributed and required principal to be preserved for the remainder beneficiaries (perhaps this was largely due to the limitations inherent in producing a variety of trust documents using a typewriter). These days it's rare for a client to be so conservative to prohibit any invasion of principal. Also, it appears that many more trust structures give the trustees the ability to accumulate income rather than require it to be distributed. This is likely partly attributable to the repeal of the "throwback rules," which used to require an onerous tax-reporting responsibility tracking the prior five years of income tax-reporting for the trust beneficiary who received an "accumulation distribution." It is also certainly attributable to the relative insignificance of the concept of fiduciary accounting income in recent times when rates on treasuries have dipped well below 1 percent. As an alternative to mandating the distribution of income, many trusts give the trust beneficiary the "right to withdraw" up to 5 percent of the trust principal each year.

Clients also need to decide how to dispose of the trust remainder after the death of the primary trust beneficiary. These days, our typical default provisions include continuing lifetime trusts for the next generation. However, most, but not all, clients like to give flexibility to the primary trust beneficiary to appoint the remaining trust principal among his or her descendants, and sometimes among a broader class of beneficiaries. While this type of power is formally referred to as a "power to appoint," it can be most useful as a power to "disappoint" a potential remainder beneficiary.

Considering the flexibility and significant benefits of trusts, we find that most clients are very interested in incorporating them into their estate plans, irrespective of whether or not a federal estate tax bill might one day be in the picture for their families. As we see it, the only downside to trusts is dealing with the slight complexities of administration and filing a separate income tax return each year (once the trusts are funded after a client dies). However, in our experience, most clients can easily adapt to dealing with the complexities of administration and the costs of the annual tax return are typically well worth the benefits that trusts can confer.

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