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The Right Trust to Best Fit Your Client's Needs

Deciding what makes sense is best left to a conversation between a client and his lawyer, after understanding the level of wealth, the family dynamics and any special circumstances.

By **Amy Neifeld Shkedy and Rebecca Rosenberger Smolen** | March 02, 2020

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The vast majority of our clients have chosen to incorporate one or more trusts into their estate plans. This may include trusts created under irrevocable trust documents established currently during a client's lifetime or trusts to be established down the road under a client's will (or revocable trust) at death. Historically, many of these trusts were established mostly for tax-planning purposes to utilize a client's federal estate tax exemption or federal estate tax annual exclusion and shelter the trust assets from further tax. While this tax-planning purpose is still very much a driving factor for many individuals, with the rise of the federal estate tax exemption (which is now at an all time high of $11.58 million), there are more clients who find themselves under the exemption amount and, thus, less in need of this type of tax planning. However, even though this tax planning purpose may not be relevant to as many individuals as it used to be when the exemption was much lower, we have found that this has not stopped our clients' desire to create trusts under their estate plans for a variety of other reasons, such as for a beneficiary's creditor protection, spendthrift protection or otherwise.

If the decision is made to create a trust, care should be taken to make sure that the provisions are properly drafted, and that the language is appropriate based on the circumstances. Trusts are certainly not one size fits all, so it's important to consider the beneficiary's needs and the client's objectives when carefully tailoring a trust. Below are some common trust provisions and considerations:

- **Income Distributions**. Many trusts have provisions that require that all of the net income of the trust be distributed to the beneficiary on an annual or more frequent periodic basis. While distributing the income of a trust may be required for certain trusts, such as certain marital trusts set up to qualify for the marital deduction, most of the time it is not necessary to incorporate a mandatory income provision in a trust document. Once this mandatory income language is drafted into the trust document, a trustee is obligated to distribute the income out each year, even if it's not advisable under the circumstances. Perhaps a beneficiary doesn't need or want the income and would prefer to have the money grow in the trust (free of estate tax) for the next generation, or perhaps there is another nontax reason why it doesn't make sense to include this type of provision. We find that it's most often advisable to have the income as a distribution in the discretion of the trustee, rather than mandate that it be distributed out each year.
- **Withdrawal Rights**. In lieu of requiring that a trust distribute all of the income to a beneficiary each year, it is often advisable to instead allow the beneficiary to have the power to "withdraw" a certain amount of the trust assets each year if he or she wants it, but without requiring that such withdrawal be made. A withdrawal right of up to 5% each year is generally recommended since amounts above that could cause an unintended taxable gift and inclusion in the beneficiary's estate for federal estate tax purposes.
- **Principal distributions**. In addition to income distributions or withdrawal rights, a determination should be made as to what other distributions from the trust's principal should be made to a beneficiary. There are some trusts which include language setting forth a mandatory distribution scheme. An example would be to distribute 1/3 of the trust assets when a beneficiary reaches age 25, 1/2 at age 30 with the entire balance at age 35. Including these types of predetermined distributions often defeat the purpose of having the trust in the first place. Perhaps when a beneficiary reaches the distribution age, he is not financially responsible, is going through a divorce, has a creditor issue or, perhaps the beneficiary has more than enough wealth and doesn't want the distribution to increase his or her future taxable estate. For these reasons, we recommend that both income and principal distributions be left in the discretion of the trustee for various purposes, which can include for a beneficiary's health, maintenance, support and education or for other purposes, such as buying a house or starting a business. When distributions are in the discretion of the trustee, the document should be carefully drafted to make sure that distributions beyond health, maintenance, support and education (which are defined by the Internal Revenue Code as "ascertainable standards") should be made by an independent trustee (i.e., not the beneficiary, a close relative of the beneficiary or a party subordinate to the beneficiary). This is to avoid the inadvertent inclusion of the entire trust in a beneficiary's taxable estate.
- **Supplemental Needs Limitations**. In some cases, it may make sense for permitted distributions to be more restrictive in the case of a beneficiary who need to be eligible to receive government benefits or other public assistance. In such cases, the allowable distribution provisions may only allow for supplemental spending beyond what needs are being met by the government or other public programs. This type of trust must be very carefully tailored to ensure that the beneficiary is adequately provided for without jeopardizing his or her benefits.
- **Sprinkle language**. It may make sense to add additional beneficiaries to a trust beyond the primary beneficiary. For example, if a trust is created for a child and that trust is going to be in existence for that child's lifetime, it may be prudent to provide that discretionary distributions can also be made to (or "sprinkled" among) the child's descendants (i.e., children and grandchildren). Adding multiple potential beneficiaries to a trust adds an extra layer of flexibility for tax planning as well as helping to

ensure that trust resources may be applied where needed.

- **Powers of Appointment**. When a beneficiary of a trust dies, the trust document provides what happens to the remaining trust assets. Typically, the balance will pass to, or in trust for, the beneficiary's own children, if any, or to a beneficiary's siblings, as the case may be. It is common to have continuing trusts for the remainder beneficiaries, often on the same terms as the deceased beneficiary's trust. Most trusts also give beneficiaries a "power of appointment" at death, which would allow a beneficiary to change the default remainder provisions of the trust and appoint the remaining trust assets at his or her death to such appointees and on such terms as the beneficiary may desire. Sometimes the permissible appointees are limited to a certain class, such as a beneficiary's descendants or a beneficiary's spouse and descendants, and other times the class is broader, allowing a beneficiary to essentially appoint the trust assets to any individuals and/or organization at his death as he may desire. In most circumstances, although there are certainly exceptions, powers of appointment in one form or another are a great way to add flexibility to trusts to account for changes based on future circumstances.

This article is meant to give our reader some of the basic provisions to consider when contemplating a trust arrangement, however, it is by no means exhaustive. There are so many variations as trusts are not meant to be cookie cutter. Deciding what makes sense is best left to a conversation between a client and his lawyer, after understanding the level of wealth, the family dynamics and any special circumstances.

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