By **Louis S. Harrison, Kim Kamin** & **Martin M. Shenkman**

The Gumby Trust: Creating Flexibility

Fourteen recommendations to consider for our exponentially changing world

The 2017 Tax Cuts and Jobs Act (the Act) dramatically changed trust planning. But many of those provisions sunset, and it's possible that a new administration may yet again change the rules. It's obvious to estate planners that trusts should incorporate more flexibility to deal with tax uncertainty. For example, flexibility in changing the income tax status of a trust might be important. However, while tax-focused planning is seductive to tax practitioners, there's so much more to consider with respect to designing trusts that can adapt to change.

If you were creating a trust 100 years ago, what would have been on your mind? World War I had just ended. Automobiles were becoming more common. There were no commercial airplanes. Babe Ruth was a pitcher for Boston. Women didn't have the right to vote. Divorce was very rare. Adopted children didn't have a right to inherit from grandparents. Children born outside of marriage were scorned and had no inheritance rights.

Consider the rapid pace of changes in social norms, technology and the law over just the past decade, let alone the past century, in terms of topics such as same-sex marriage, gender identity, assisted reproductive technologies, digital assets and cryptocurrencies. And of course, the tax landscape is always changing.

The process in which we do estate planning hasn't changed at near this pace. Too often, the manner in which practitioners endeavor to help families plan is mired in our past ways of doing things rather than thinking ahead and planning for the next 100 years. With the trend toward longer lasting (even perpetual) trusts, most trusts are being designed to contemplate that they'll still exist in hundreds of years, if not longer, if the assets aren't fully depleted sooner.

With this in mind, we're in the chorus of those singing about the need to draft trusts for flexibility. Let's consider 14 recommendations for creating a fully flexible "Gumby" trust (name based on the green, clay, animated character of yore) that can change with the times.

Continue Sophisticated Planning

For many wealthy clients, there may be little need in today's environment for estate tax planning. But, given the frequent changes, estate planners consider continuing to integrate estate and generation-skipping transfer (GST) tax planning into new instruments. While it's impossible to anticipate future changes, having more flexibility should the exemption be reduced or the estate grow is advisable. The most flexible estate plan incorporates almost all of the possible trusts that should be created at the first spouse's passing:

1. Bequeath property up to the decedent's available GST tax and federal exemption into a family trust, or fund the family trust with a lesser amount if full funding would incur state estate tax, for basis step-up or if, for other reasons, such as protection of the surviving spouse, it's decided that it would be better to underfund the family trust. In some cases, practitioners might prefer that all assets pass to a qualified terminable interest property (QTIP) trust for full basis step-up on the death of the second spouse but that precludes the flexibility of a credit shelter trust (CST) with spray provisions, which can provide personal,

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economic and income tax benefits.

2. Bequeath the non-qualified property that's included in the decedent's estate for federal estate tax purposes to the GST family trust, but only to the extent that the value of this property as finally determined for federal estate tax purposes doesn't exceed the available GST exemption amount. Give any remaining non-qualified property to the trustee to hold in the family trust.
3. Give the state exempt gift to the GST family trust, and hold the non-GST state exempt gift portion in the family trust.
   (a) Bequeath the excess federal exemption gift to the GST-exempt trust.
   (b) Bequeath the residue gift to the GST marital trust, and hold the non-GST residue gift portion in the non-exempt marital trust.

This can be accomplished by drafting carefully to use a combination of disclaimer planning and *Clayton* QTIP elections. But, it can be complicated. While most clients abhor complexity, flexibility should really be the objective. Even so-called "simple" trusts require a team of professional advisors to administer them properly. No client would refuse to see a specialist recommended by her internist, and there's similarly no reason clients should logically not permit a team approach to provide proper estate planning and trust administration.

As an alternative, some find it easier to use a bequest that says: "I give the balance of the trust estate to the trustee to hold as the marital trust." And, you can.

Consider Single Fund QTIP

Instead of always using a marital deduction formula, consider the single fund QTIP trust with permission for disclaimer and *Clayton* elections as the estate tax formula of choice, essentially delaying the decision on the funding amounts for each trust (state exempt trust, federal exemption trust, marital trust and portability considerations) until the first spouse passes away.

You can make decisions on portability, the use of a CST and deferral of state inheritance tax at a later date.

Exercise caution with some of the new fangled provisions that add flexibility to be certain that they don't disqualify the trust intended to qualify for the marital deduction. For example, if a trust protector can add beneficiaries, that may result in an argument that the spouse isn't the sole beneficiary during the spouse's lifetime unless the instrument is clear that no party can amend a trust that's electing QTIP treatment to add beneficiaries to that trust. While a trust protector likely should be used in most instruments, be wary of standard provisions without considering the above possible implications.

Evolving social trends is another important reason to include a decanting provision in the trust instrument as well as a change of situs mechanism.

Avoid Gendered Pronouns

At the turn of this century, same-sex spouses were unthinkable by many, and yet now they're legal in the United States and many other countries. In the future, what will be permissible? Plural marriage? Other arrangements? To keep documents flexible in tone, avoid terminology like "husband" and "wife" or any other gendered nomenclature in drafting. Consider using just "spouse." Evolving social trends is another important reason to include trust protector and decanting provisions in the trust instrument as well as a change of situs mechanism. If the old language doesn't suffice, amending or decanting into a new instrument (and perhaps moving to a state with more favorable law before doing so) can provide the flexibility to modernize the trust as necessary.

Use Broad POAs

Consider broader powers of appointment (POAs), for example to anyone other than creditors, the estate, self or creditors of the estate. But, as with so many suggestions for flexibility, planning must be tailored or granular to the particular client. Some client circumstances will be best served by a very broad special POA, while others require more limited POAs. But, the incorporation of POAs into documents has and will continue to grow in importance as a tool to add flexibility to plans. However, the growing use of powers demands that estate planners encourage clients to come back for periodic reviews (annually being ideal) to go over and fine tune the implications of powers and other concerns.

> Consider adding trust protectors for revocable trusts as checks and balances on the trustees.

The most flexible option is for the trust instrument to provide both lifetime (other than for a QTIP marital trust) and testamentary broad limited POAs. To maximize privacy and flexibility, drafters should be wary of creating a testamentary POA that can be exercised only by will. Instead, it's prudent to allow the power to be exercised by any instrument that specifically references the POA and is delivered to the trustee of the irrevocable trust over which the POAs are being exercised.[1]

Consider Trust Protectors

Some practitioners remain uncomfortable enabling trust protectors to amend trusts. Those fears should have long since passed, and permitting a trust protector to make changes to trusts has become the norm. Also, different people/positions may be provided for in addition to a trust protector to enhance flexibility (for example, a power to loan trust assets to the grantor or to add a charitable beneficiary). Note that it isn't necessary to name a trust protector in the instrument if there isn't an obvious candidate, and you don't want to involve a third party in the trust initially. But at a minimum, the trust could permit someone to be appointed who can make amendments to the trust.

If the trust protector will be empowered to add or remove individual beneficiaries, then it's preferable to frame that instead as a "special power holder" and grant to that individual a special POA that permits changing beneficiaries or appointing the trust into a new trust with different terms. If the trust protector is designated as (or might be interpreted by a court or applicable state law as) acting in a fiduciary capacity, then a separate person who can act in a non-fiduciary capacity, and not the protector, may be better to hold powers to change beneficiaries. If a trust protector is acting in a fiduciary capacity, can she add or change beneficiaries to whom she owes a fiduciary duty?

The courts and law have viewed revocable trusts as a will substitute and, as such, have struggled to find remedies when elder abuse or other issues are perpetrated by a trustee during the settlor's lifetime. Consider adding trust protectors for revocable trusts as checks and balances on the trustees. This can be an important safeguard with aging clients.

Consider protections in all trusts along with express decanting powers, special limited POAs or broader trust protector provisions. Give thought as to who should hold these powers, the status of the position that's granted each power and the impact on the overall plan.

Consider Power to Substitute Assets

Consider including the power to substitute assets. This power becomes especially important as the estate tax exemption increases and income tax planning becomes more relevant for step-up in basis purposes. In many settings, a grantor of a grantor trust may want to substitute high basis assets for low basis assets, and the substitution power is one way this can be achieved (a purchase agreement is another). These benefits are also why the view that non-grantor trusts are the new default planning tool can be inadvisable. For ultra-high-net worth clients, it may be preferable that certain of their assets be held in grantor trusts for basis step-up purposes via the swap power and other assets be distributed to non-grantor trusts that don't need the possible benefits of the swap power.

Name Charitable Beneficiaries

Consider granting someone the power to add charitable beneficiaries in grantor irrevocable trusts. This power


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should characterize the trust as a grantor trust. It may reduce amounts going to beneficiaries,[2] thereby providing a disincentive for beneficiaries to challenge trustee actions. Use caution in deciding how this power or similar or related powers are used.

Given the post-Act increase in the standard deduction, it can be advantageous for many clients to structure non-grantor trusts with charitable beneficiaries so that they can use the Internal Revenue Code Section 642(c) deductions to claim a 100 percent deduction of donations, whereas the same settlors might have realized no deduction had the donations been made personally because of the doubled standard deduction.

It may be beneficial to change trust situs to a more favorable jurisdiction for state income tax and creditor protection purposes.

This must be distinguished from giving a power to add charitable beneficiaries, which would characterize the trust involved as grantor for income tax purposes, thereby defeating the hoped-for income tax benefits.

In all events, the flexibility to add or give to charity in irrevocable trusts can provide further flexibility to irrevocable trust plans.

Grantor Trust Status Turnoff

Consider the flexibility of providing a mechanism so that grantor trust status can be turned off. There are a number of ways to accomplish this. The settlor should have the power to renounce a grantor trust power. A spouse acting as trustee could have the power to resign. And, a trust protector should have the power to amend the trust both to add or remove grantor trust powers. Finally, in most states, there should be a provision permitting the trustee to reimburse a grantor for taxes paid.

The IRS permits reimbursement for taxes and won't include the amount of the trust in the settlor's taxable gross estate as long as the payment isn't: (1) forbidden by state law, (2) subject to a pattern of abuse that suggests an agreement to reimburse, or (3) mandatory. In Revenue Ruling 2004-64, the Internal Revenue Service addressed this issue and determined that there would be no inclusion in the gross estate for federal estate tax purposes if the trustee has discretionary authority, under the instrument or applicable local law, to reimburse the grantor for the income tax liability. There must not be any facts indicating control by the grantor, such as pre-existing arrangements, powers to name the grantor as trustee or local law subjecting the trust assets to the claims of the grantor's creditors. On the other hand, if the trust's governing instrument were to require a mandatory payment for the income tax liability, this would trigger inclusion in the grantor's taxable gross estate under IRC Section 2036(a)(1).

Trust Conversion

Closely related to the power to turn off grantor trust status above is the flexibility to transform a grantor trust into a non-grantor trust and vice versa. But, be cautious of possible adverse income tax implications (for example, converting a grantor trust into a non-grantor trust while the trust holds a note resulting from a note sale transaction). Income tax status planning and allocation of taxation to different parties under trusts will continue to be critical going forward. Third parties, perhaps special power holders (not trustees because fiduciary capacity may inhibit or prevent the exercise of certain powers) need to have the power to convert from grantor to non-grantor trust and back again.

This can be accomplished in a variety of ways. In certain jurisdictions, merely having the decanting power will facilitate going from non-grantor trust status to grantor trust status. For example, this approach is arguably allowed in Illinois by decanting to a trust in which the original grantor has grantor trust powers. Also, consider potential legal liability from a conversion. If a grantor trust is decanted into a non-grantor trust, might the beneficiaries sue the trustee effectuating the decanting for creating a cost to the trust or beneficiaries that had theretofore been borne by the settlor?

Allow for Change of Situs

It may be beneficial to change trust situs to a more favorable jurisdiction for state income tax and creditor protection purposes. Include both change of situs

and trustee designation provisions in the documents, and discuss the benefits to clients at a follow up estate-planning meeting.

Provide Creditor Protection

Lawsuits are becoming more plentiful, especially plaintiff actions. People are greedy, lawyers are creative, life is more complicated and people are getting more entitled. All variables to increase the abundance of lawsuits.

Most clients, certainly those educated on possible options, want to establish trusts for creditor protection purpose. Consider several mechanisms to enhance creditor protection and thereby infuse more flexibility into the trust, for example: (1) beneficiary trustees should be able to renounce their trusteeship, and (2) trusts should provide for the appointment of independent and even institutional successor trustees, change in situs and governing law and discretionary distributions only by independent trustees.

Give Each Generation a POA

Make sure each generation has a testamentary POA, broader than just to descendants. Consider adding trust protectors to allow change in the terms of trusts. Clients should meet regularly with an advisor team to address these issues. Further, at some point in that periodic review meeting process, the next generation should be brought in to the extent appropriate so the planning, including use of powers, can be monitored and used as appropriate.

Expand Definition of "Child"

Considering all the forms of assisted reproductive technologies like artificial insemination, in vitro fertilization and surrogacy, genetic manipulation and designer babies are likely to increase. Family definition provisions regarded as state of the art a decade ago are already outdated. Endeavor to use definitions of "child" or "descendant" that are broader.

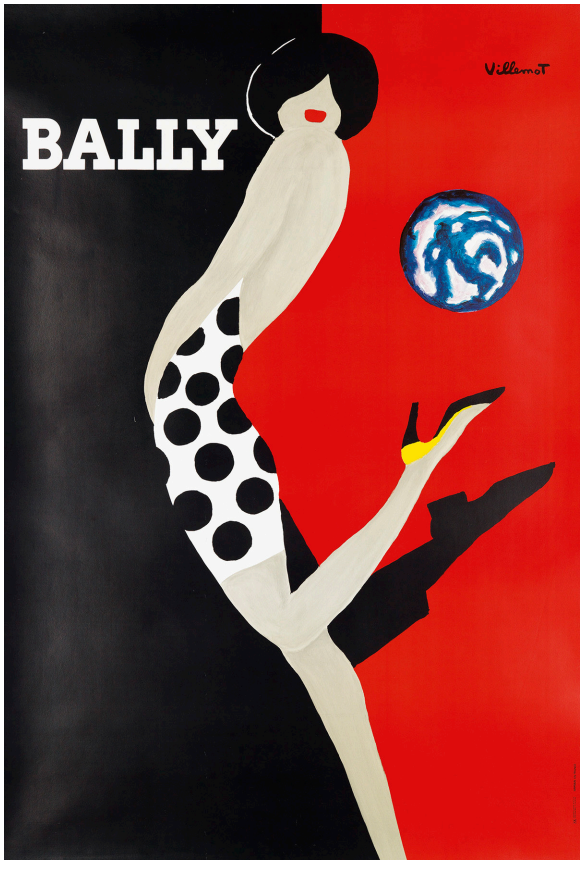
Allow Beneficiaries to Move Abroad

The world is becoming a much smaller place. Will our clients' descendants continue to be U.S. citizens? Is their security in place? What kind of food considerations will be more relevant in the future? All things considered, we in the United States are doing quite well, but what will the United States be like in 50 years? Consider distribution of funds to allow beneficiaries to move to jurisdictions outside of the United States or to allow distributions for security measures for beneficiaries.

Endnotes

1. *See* Private Letter Rulings 9352017 (Dec. 30, 1993) and 9239015 (Sept. 25, 1992).
2. Internal Revenue Code Section 672(b).

—This article is based on the outline created by Louis S. Harrison for the T&E Advisory Panel at the 2018 Notre Dame Tax and Estate Planning Institute in South Bend, Ind.



SPOT LIGHT

Kick Up Your Heels

Bally, 1989 by Bernard Villemot sold for $1,560 at Swann Auction Galleries' Vintage Posters auction on Aug. 1, 2018 in New York City. Villemot was one of the most recognized poster designers of his generation—working on campaigns for major brands including Bally, Perrier, Air France and Orangina.