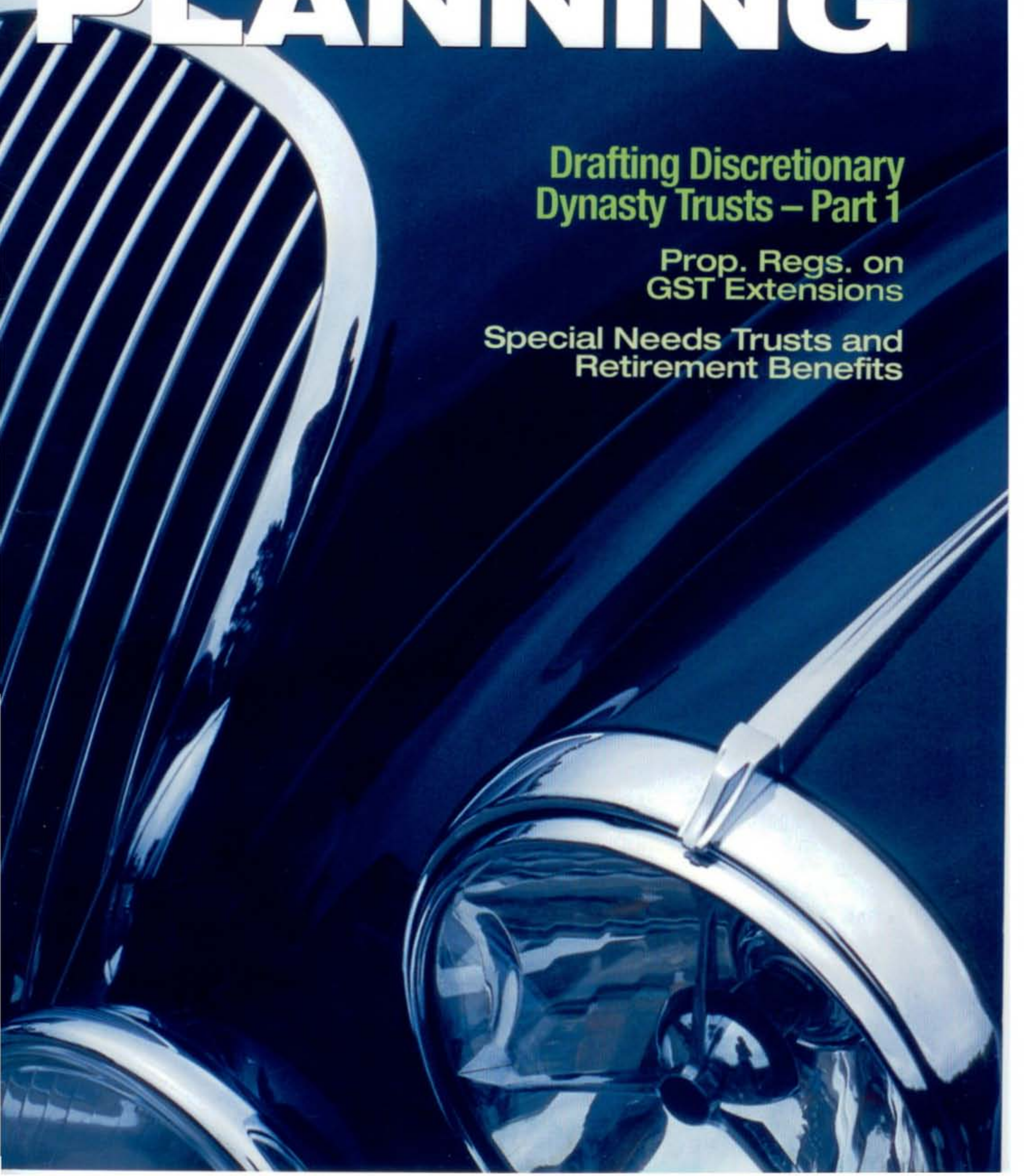
February 2009

ESTATE PLANNING



Drafting Discretionary Dynasty Trusts – Part 1

Prop. Regs. on GST Extensions

Special Needs Trusts and Retirement Benefits

How to Draft Discretionary Dynasty Trusts—Part 1

There are at least five major benefits to leaving a child's inheritance in trust. Part 1 of this three-part article analyzes the nine keys to drafting a discretionary dynasty trust and introduces the three common methods of drafting these trusts.

MARK MERRIC, ATTORNEY

Several articles have been written in various publications regarding the advantages of beneficiary-controlled trusts™, inheritor's trusts™, or the more generic term: discretionary dynasty trusts.[2] These articles note that a large wave of estate planners are changing distribution standards and vesting options from an ascertainable standard and age vesting to a discretionary dynasty trust.

Fourteen years ago, 90% of the trusts that I drafted were "age vesting" with an ascertainable standard. The other 10% were discretionary dynasty trusts. Now those figures are reversed. Almost 90% of the trusts I currently draft, including any marital[3] or credit shelter trusts, are discretionary dynasty trusts. Because most of my clients are not ultra wealthy, why do almost all of them choose a discretionary dynasty trust?

Trend toward a new method of drafting

The primary reason estate planners are drafting discretionary dynasty trusts is to protect a child's inheritance. The second reason, which used to be the primary reason, is to allow the trust property to be transferred from generation to generation to the extent the trust was exempt for generation-skipping transfer ("GST") tax purposes.

For spousal lifetime access trusts, a common law discretionary trust precludes the estate inclusion issues associated with a trust that gives the spouse an enforceable right to a distribution.[4] For a self-settled estate planning trust (i.e., a rainy day trust™[5]), a common law discretionary trust precludes one of the possible estate inclusion issues. Because the settlor/beneficiary holds neither an enforceable right to a distribution nor a property interest, trust property is not brought back into the settlor's estate under the IRC Section 2036(a)(1) life interest rule.[6]

Another reason for the recent popularity of discretionary dynasty trusts is that the settlor can control the property through a limited liability company ("LLC") or family limited partnership ("FLP") that is partially or almost completely owned by the discretionary dynasty trust.[7]

The use of trusts to reduce estate tax is another reason. Related to the reduction of estate tax advantage is that a discretionary dynasty trust can be designed to use only *Crummey*[8] beneficiaries, rather than rely-

MARK MERRIC is the principal in the Merric Law Firm, which is a boutique firm in Denver emphasizing activity in the areas of estate planning, international tax, and asset protection planning. He is co-author of CCH's treatise on asset protection—*The Asset Protection Planning Guide* (first edition), and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I* and *Asset Protection Strategies Volume II*. He has been quoted in *Forbes, Investor's News, On the Street*, the *Denver Business Journal, Oil and Gas Investor*, and the *Sioux Falls Business Journal*. For details on his monthly webinars as well as speaking events, go to www.internationalcounselor.com/HotoffthePress.htm.

EXHIBIT 1
The First Three Keys to Drafting

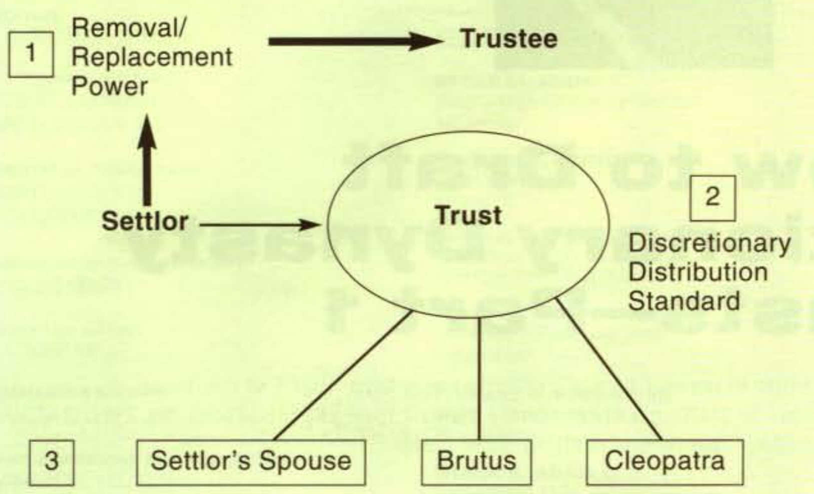
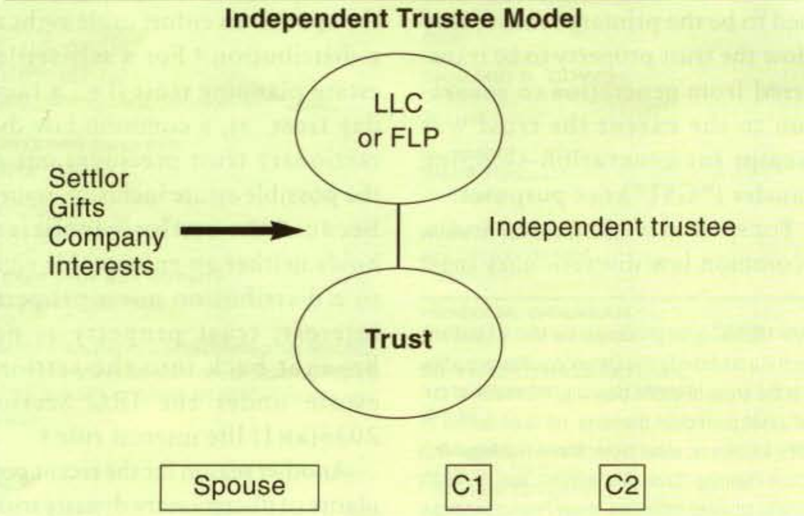


EXHIBIT 2
Independent Trustee



ing on *Cristofani*[9] beneficiaries. These, along with many more positive features, are the solidifying reasons that the tide of estate planning drafting has turned in favor of using discretionary dynasty trusts.

What types of trusts this article is not addressing

This three-part series of articles discusses trusts where parents, grandparents, or a third person leave his or her property in trust for the benefit of children, grandchildren, or some other person. These are referred to as third-party trusts. This article addresses only briefly the asset protection behind certain types of self-settled trusts, in which the settlor places his or her own property.

The general rule is that to the extent of the settlor/beneficiary's interest, there is no asset protection for a self-settled trust. With a self-settled irrevocable trust, a creditor may reach the maximum amount that may be distributed by the trustee to the settlor/beneficiary.[10] With a trust that is fully discretionary as to income and principal, this would be the entire trust corpus.[11] With a support trust, this may well be the entire trust corpus or possibly a lesser amount.[12] A revocable trust (also known as a living or "loving" trust) provides no asset protection whatsoever—*even* if the trust contains spendthrift provisions.

Many times, there are partially incorrect postings on national listserves stating that charitable remainder unitrusts ("CRUTs") and qualified personal residence trusts ("QPRTs") are asset protected. Charitable remainder trusts and grantor retained income trusts are also self-settled trusts to the extent of the income interest, and a creditor can reach the settlor/beneficiary's interest in such trust.[13] A QPRT is a self-settled trust as well, and a creditor would be able to attach the debtor's right to live in the residence.[14] However,

1 "The Modular Approach to Estate Planning" is trademarked by Mark Merric.

2 "Beneficiary-controlled trust" and "inheritor's trust" are trademarked by Richard Oshins, Steve Oshins, and Noel Ice.

3 In most of the structures that the author drafts, the marital trust pours into the credit shelter trust upon the death of the second spouse.

4 A common law "support trust" creates an enforceable right for a spouse to demand a distribution based on an ascertainable standard such as "health, education, maintenance, and support" combined with a direction to the trustee that the trustee must (e.g., "shall") make distributions pursuant to the ascertainable standard. Absent a savings clause, distribution language that looks to the settlor's support obligation for a spouse, or common law that holds the trustee is to look to the beneficiary's resources including the obligation of a settlor to support a spouse, there is an estate inclusion issue with these inter vivos trusts. For further discussion of this issue, see Merric, "Spousal Access Trusts—The Good, the Bad, and the Ugly—Part I," Stephan Leimberg's LISI Estate Planning Newsletter #1334, #1352, and #1379 (www.leimbergservices.com) (8/20/08, 10/14/08, 12/2/08, respectively).

the right to live in a homestead may possibly be protected by a homestead exemption.[15] Therefore, the general rule is this: to the extent an irrevocable trust is self-settled, a creditor may reach the assets of a QPRT.

An important exception to the self-settled trust rule is domestic and offshore asset protection trusts. These trusts are self-settled but, by statute or common law, they provide the asset protection of a third-party trust to the settlor/trustee's beneficial interest.[16]

It is beyond the scope of this article to address asset protection trusts. Rather, this article discusses protecting a child's beneficial interest in a third-party trust.

EXHIBIT 3
Managing/Distribution Trustee

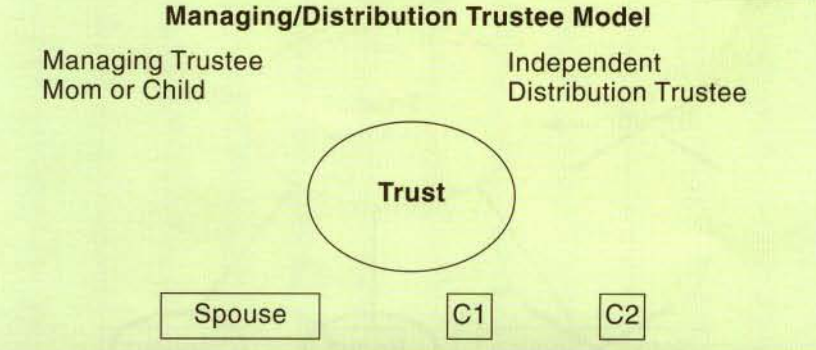
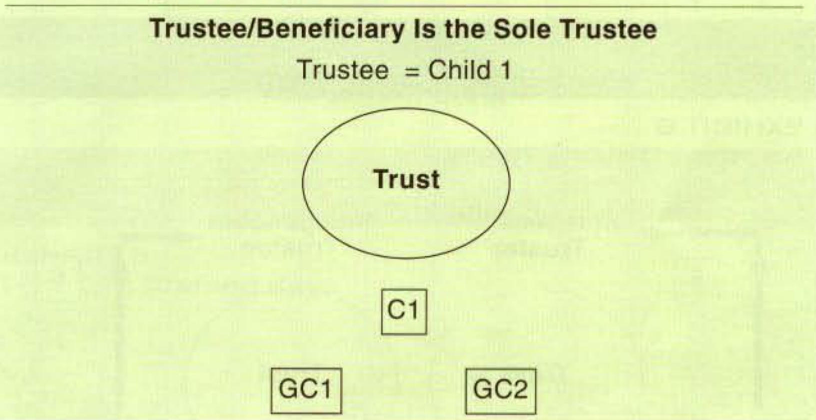


EXHIBIT 4
Beneficiary Is Sole Trustee



Nine drafting keys to a discretionary dynasty trust

There are nine keys to drafting discretionary dynasty trusts. Exhibit 1 helps present the first three keys.

Key 1—Removal/replacement power. Until the death of the settlor (or possibly the later death of the settlor's spouse), the settlor retains the right to remove and replace a trustee who is independent within the meaning of Section 672(c). However, upon the death of the settlor (or the later death of the settlor or settlor's spouse), this removal/replacement power vests in the child (assuming the child is over a certain age, such as 30 or 35).

Key 2—Common law discretionary distribution standard. Most of the time, the trust is drafted as a common law discretionary trust, and the beneficiary does not have an enforceable right to a distribution or a property interest in the trust. Rather, the beneficiary holds nothing more than a mere expectancy. Under the Restatement Second of Trusts and almost all case law, the distribution language would provide that the trustee would make distributions in its sole and absolute discretion and include a standard for making a distribution. Furthermore, the trustee would have the power to make unequal distributions among the beneficiaries.

The Restatement Third of Trusts takes a radical departure from common law on how drafters must now draft discretionary distribution standards. Some of the key trust states such as South Dakota and Delaware, as well as some Uniform Trust Code states such as Missouri and Florida, have made modifications by statute to codify parts or all of the Restatement Second of Trusts. The question

5 "Rainy day trust" is a trademark held by Alaska Trust Company.

6 Several hurdles must be surmounted to avoid estate tax inclusion of a self-settled estate planning trust. One of these hurdles is that the settlor must not have a life interest (i.e., an enforceable right) to a distribution under Section 2036(a)(1). Another is that a creditor cannot be able to reach the settlor/beneficiary's interest. With a common law discretionary trust, the settlor has neither an enforceable right to a distribution nor a property interest to attach. For more on this issue, see Merric, "Estate Inclusion Issues of Reciprocal Trusts and Self-settled Estate Planning Trusts," Stephan Leimberg's LISI Estate Planning Newsletter #1339 and #1370 (9/5/08 and 11/13/08).

7 The drafter must follow the rules to avoid the bad fact estate inclusion issues under Sections 2036(a)(1) and 2036(a)(2).

8 Crummey, 397 F.2d 82, 22 AFTR2d 6023 (CA-9, 1968).

9 Estate of Cristofani, 97 TC 74 (1991).

10 Restatement Second of Trusts, § 156, and comments d. and e. Hughes, 104 F.2d 144, 23 AFTR 24 (CA-9, 1939); Byrnes, 110 F.2d 294, 24 AFTR 483 (CA-3, 1940); Nelson v. California Trust Co., 202 P.2d 1021 (Cal., 1949); Greenwich Trust Co. v. Tyson, 27 A.2d 166 (Conn., 1942).

EXHIBIT 5
Dynasty Trust Splits

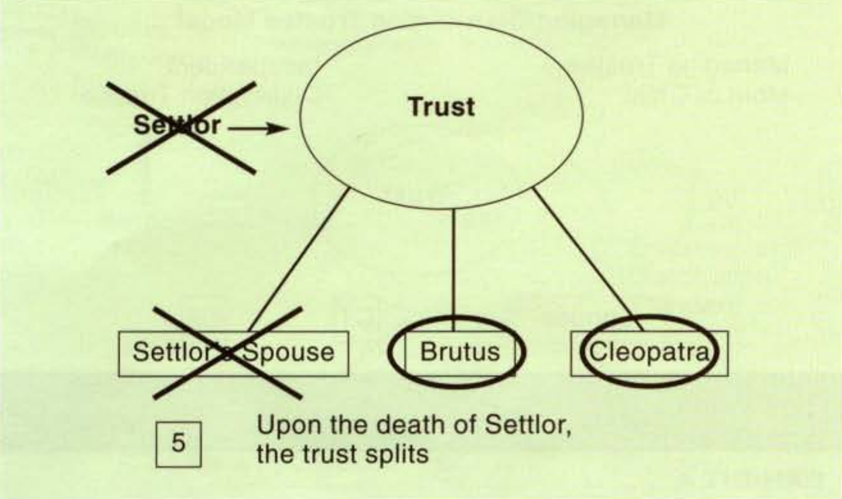
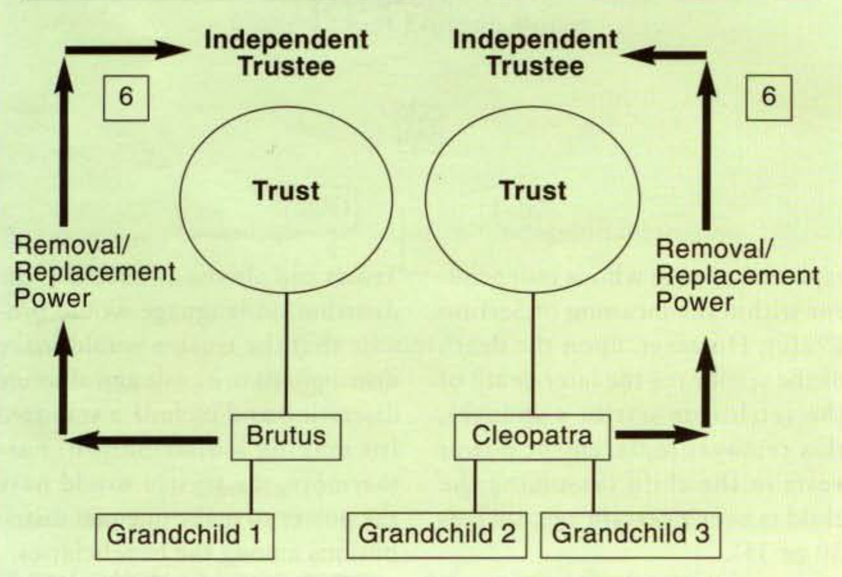


EXHIBIT 6
Separate Dynasty Trusts



of drafting the discretionary distribution standard will be discussed in detail in Part 2 of this article, which will appear in the next issue of ESTATE PLANNING.

Key 3—Spousal access. The "settlor's spouse" is named as a beneficiary. The trustee may now, under the discretionary distribution standard, make distributions to the settlor's spouse. These distributions may be used for family purposes.

Naming a spouse as a beneficiary may concern some clients who may fear a possible divorce; the client would not want an estranged spouse suing the trustee for distributions. Therefore, rather than using the spouse's name, the spouse should be a beneficiary only if he or she is married to the settlor.

Methods of drafting

Key 4—Three models of discretionary dynasty trusts. There are primarily three different methods for drafting discretionary dynasty trusts. The first method is the most protective because it has only an independent trustee. The second method uses a managing trustee, who is usually the settlor's spouse or child, and an independent distribution trustee. The third method uses the primary beneficiary, usually a child, as the sole trustee.

When discussing the closeness of the trustee to the settlor, the asset protection issue that one needs to be concerned about is the question of "dominion and control." "Dominion and control" means that the settlor controls the trust so much that it should be disregarded for all creditor purposes. A sole independent trustee is at a greater distance from a dominion and control attack by creditors than when a beneficiary is the sole trustee. Conversely, the use of an independent trustee may conflict

11 Restatement Second of Trusts, § 156(2). In Re Robbins, 826 F.2d 293 (CA-4, 1985); Credit Corp. v. Chase Manhattan, 473 N.Y.S.2d 242 (N.Y. Sup. Ct. App. Div., 1984); Cooke Trust Co., Ltd. v. Lord, 41 Hawaii 1993 (1955); Crane, for Use of Niemeyer v. Illinois Merchants Trust Co., 238 Ill. App. 257 (1925).

12 Restatement Second of Trusts, § 156, comment d. Wolfe v. Wolfe, 21 Mass. App. Ct. 254, 486 N.E.2d 747 (1985); In re Spenlinhauer, 195 B.R. 543 (DC Me., 1996); In re Porras, 224 B.R. 367 (W.D. Tex. Bkrtcy. Ct., 1998); Ahern v. Thomas, 248 Conn. 708, 733 A.2d 756 (1999).

13 In Re Mack, 269 B.R. 392 (DC Minn., 11/2/01), and In re Brown, 303 F.3d 1261 (CA-11, 2002), are both charitable remainder trust cases where the creditor reached the settlors' income interests.

14 In In re Frangos, 132 B.R. 723 (N.D. Ohio Bkrtcy., 1991), and In re Frangos, 135 B.R. 272 (N.D. Ohio Bkrtcy., 1992), the trust was not a qualified personal residence trust in conformity with the Internal Revenue Code. However, the settlors did transfer their house into trust, with the life interest in the house remaining in the settlors and the remainder interest going to their children. The court held the entire residence could be reached by the creditors, rather than just the life interest.

with the settlor's wishes if he or she wishes to name a spouse or child as a sole trustee or managing trustee. The issue of dominion and control will be discussed in detail in Part 3 of this article.

Independent Trustee with a Tiered FLP or LLC. Exhibit 2 shows the first common method for drafting a discretionary dynasty trust.

The general rule is this: The greater distance that the settlor is from the structure, the more likely a creditor's "dominion and control" argument will fail. An independent bank or corporate trustee provides the greatest distance from the settlor. An attorney or CPA serving as a trustee provides a fair distance. On the other hand, one should not confuse the asset protection concept of an independent trustee with the estate tax inclusion concept as discussed in Rev. Rul. 95-58.[17] Under this Ruling, your uncle, wife's brother or sister, grandparents, and your best friend are all independent. While there is currently no case law on point, a court may not find that your best friend is as independent as one would like.

The client typically retains control over the management of the assets held by the LLC in his or her capacity as manager of the LLC or

EXHIBIT 7
Distributions to One Beneficiary

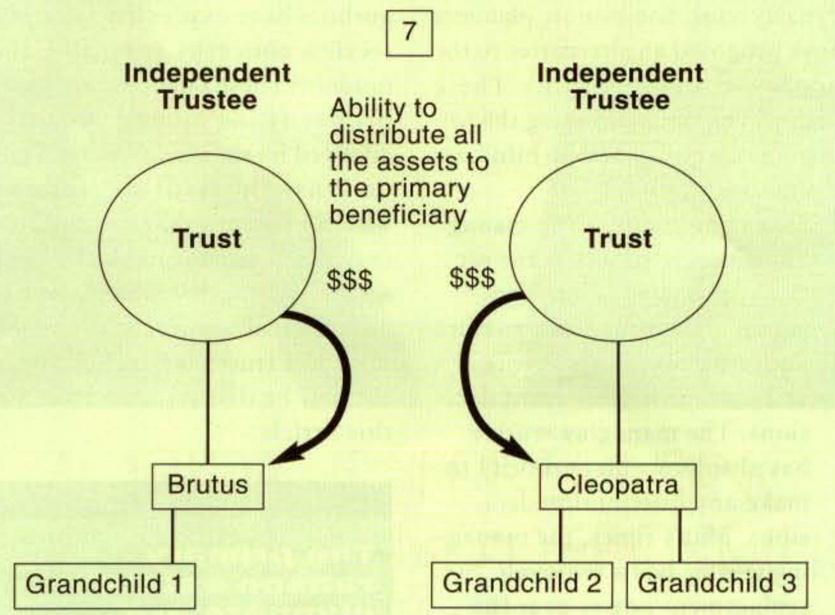
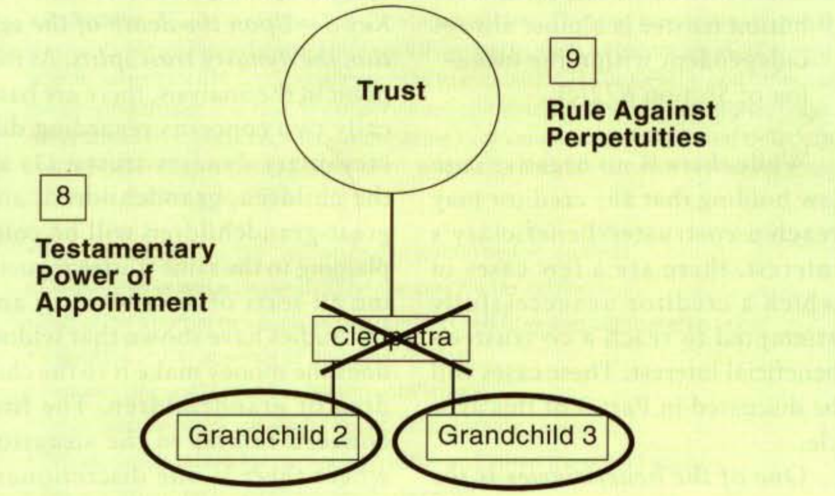


EXHIBIT 8
Last Two Drafting Keys



general partner of the FLP as well as holding a removal/replacement power over the trustee. If the client is serving as manager, the planner must still design around any Section 2036 estate inclusion issue.

On a different note, some clients might express a concern that an attorney or CPA trustee that is not bonded might abscond with the trust assets. From an internal control perspective, with the above model, the attorney or CPA does not have any access to the assets held by the underlying LLC or FLP.

15 Nolte v. White, 784 So. 2d 493 (Fla. App. Dist. 4, 2001); Ronald v. Welbaum, 664 So.2d 1 (Fla. App. Dist. 3, 1995).

16 In offshore jurisdictions and South Dakota, it is the discretionary nature (i.e., where a beneficiary does not have an enforceable right or property interest) that provides the asset protection. The domestic asset protection statutes provide spendthrift protection for a self-settled trust. South Dakota has two statutes that address domestic asset protection trusts—the qualified disposition trust that provides spendthrift protection, and the discretionary/support classification statute that provides the common law discretionary asset protection.

17 1995-2 CB 191. If a settlor of a discretionary trust holds an unconditional removal/replacement power over a trustee, Rev. Rul. 95-58 provides a safe harbor as long as the settlor can concurrently remove and replace the trustee with someone who is independent within the meaning of Section 672(c).

Managing beneficiary trustee and independent distribution trustee. Exhibit 3 presents a diagram of the second common method for drafting a discretionary dynasty trust. Some estate planners have proposed an alternative to the upper tier LLC (or FLP). These planners recommend using the following two co-trustees to bifurcate the trustee's powers:

1. *Managing trustee.* The managing trustee typically is the settlor's spouse or child. The managing trustee has signature authority over investments and makes all investment decisions. The managing trustee has absolutely no authority to make any distribution decisions. Many times, the managing trustee has a removal/replacement power over the distribution trustee.
2. *Independent distribution trustee.* The distribution trustee's only function is to make distribution decisions. To avoid any possible estate tax inclusion issues, the distribution trustee is almost always independent within the meaning of Section 672(c).

While there is no negative case law holding that any creditor may reach a *co*-trustee/beneficiary's interest, there are a few cases in which a creditor unsuccessfully attempted to reach a co-trustee's beneficial interest. These cases will be discussed in Part 3 of this article.

One of the beneficiaries is the sole trustee. Exhibit 4 illustrates a diagram of the third common method for drafting a discretionary dynasty trust. While used by some practitioners, this design option is limited when compared to the other two previous options. Because the distribution standard must be limited by an ascertainable standard (e.g., health, education, maintenance, and support), all the trust assets cannot be distributed to the primary child beneficiary. Furthermore, some authors have expressed asset protection concerns regarding this model.[18] These concerns are based primarily on a new position adopted by the Restatement Third of Trusts in favor of creditors which provides that any creditor may reach any sole trustee's interest in any trust.[19] The dominion and control argument for reaching a sole trustee's beneficial interest will be discussed in Part 3 of this article.

The primary reason estate planners are drafting discretionary dynasty trusts is to protect a child's inheritance.

Split of dynasty trust

Key 5—Upon the death of the settlor, the dynasty trust splits. At this point in the analysis, there are basically two concerns regarding discretionary dynasty trusts: (1) all the children, grandchildren, and great-grandchildren will be complaining to the same trustee requesting all sorts of distributions; and (2) studies have shown that seldom does the money make it to the children or grandchildren. The first concern relates to the situation where there is one discretionary dynasty trust, sometimes known as a "pot trust."[20] In Exhibit 5, Brutus and Cleopatra are the children. From history, we know that these two never got along ever since Brutus stuck the knife in Cleopatra's lover's back, "Big Julie."

Since naturally there will be fights between siblings or—worse yet—grandchildren and great-grandchildren, a pot trust is not used. Rather, upon the death of the settlor (or if a first marriage, the last of the settlor or settlor's spouse), the trust will split into multiple discretionary dynasty trusts at each generation. Brutus now has his own discretionary dynasty trust, and Cleopatra has her own discretionary dynasty trust. The two never have to speak to each other again. Brutus is now responsible for keeping his family in line, and Cleopatra hers.

Regarding the second concern, the purpose of these trusts is not to make sure that there is money to be available to the grandchildren or great-grandchildren. Generally, one of the primary purposes is asset protection of the child's beneficial interest by giving him or her the benefits of receiving his or her inheritance in trust. If the child does not consume his separate dynasty trust or the child does not exercise his or her testamentary power of appointment, then upon the child's death what is left in trust goes to the grandchildren in separate dynasty trusts.

Trust administration

Key 6—Cascading removal/replacement powers. Assuming Brutus and Cleopatra have reached a specified age of maturity (age 30, 35, or 40), each child receives a removal/replacement power over the trustee. Because each child has a separate trust, different trustees may serve on each separate dynasty trust, and each trustee may make investment decisions independently of the other trustee(s) of the other

[18] Harris and Klooster, "Beneficiary-Controlled Trusts Can Lose Asset Protection," 145 Tr. & Est. 37 (Dec. 2006).

[19] Restatement Third § 60, comment g.

[20] The trust is analogized to a big pot of soup where all of the beneficiaries line up to fill their bowls.

Practice Notes

There is a new wave of drafting trusts that is based on combining the asset protection benefits of a discretionary dynasty trust with the estate planning benefits of discounting entities.

child's trusts. This is illustrated in Exhibit 6.

Key 7—Trust assets may be distributed to the primary beneficiary. One of the fundamental keys to a discretionary dynasty trust is that the beneficiary is willing to receive his inheritance in trust, rather than outright. During the beneficiary's life, if a beneficiary must share the trust assets with his or her children, then the beneficiary would possibly prefer not to receive his or her inheritance in trust. Thus, most children receiving their property in trust prefer that a trustee have the power to distribute all the assets of the trust to the primary beneficiary, should the trustee choose to do so. In addition to the asset protection benefits, this is why the trust must be drafted as a "common law discretionary trust," so that the trustee in his or her sole and absolute discretion has the ability to make distributions to one beneficiary and exclude all others. This is shown in Exhibit 7.

Last two drafting keys

Exhibit 8 illustrates the final two keys to drafting a discretionary dynasty trust.

Key 8—Testamentary power of appointment. At death, Cleopatra would like to treat the trust as if it were her assets. Consequently, it is typical to give Cleopatra a testamentary power of appointment to redirect the trust assets, usually among her descendants. If Cleopatra does not exercise her testamentary power of appointment, the default provision is that the trust splits into two separate discretionary dynasty trusts, one for each one of her children (i.e., the settlor's grandchildren).

There are primarily three different methods for drafting discretionary dynasty trusts.

Key 9—Rule against perpetuities. Naturally, it is preferable that these trusts be created in a jurisdiction that has abolished the rule against perpetuities. Conversely, as related to the children, it does not matter whether or not the trust is created in a jurisdiction that has abolished the rule against perpetuities. If a trust must vest in 21 years plus a life in being, it will automatically survive to the grandchild level, and maybe the next generation. In this respect, the child does not hold any vested remainder which may be considered a property interest or an enforceable right that might create a creditor or divorce issue under state law.

Conclusion

There are at least five major benefits to leaving a child's inheritance in trust. For all families, there are the asset protection benefits provided by receiving a beneficial interest in trust. From an estate perspective, there are the benefits of reducing the estate tax, and for more wealthy families, there is the benefit of avoiding the GST tax. Being able to gift the property away and still control these assets by serving as a manager or general partner of an LLC or FLP are also great benefits. Finally, being able to have some property distributed back to the family unit through a spousal access trust is another useful advantage.

There is a new wave of drafting trusts that is based on combining the asset protection benefits of a discretionary dynasty trust with the estate planning benefits of discounting entities. Part 1 of this article analyzed the nine keys to drafting a discretionary dynasty trust and introduced the three common methods of drafting these trusts. Part 2 of this article, which will appear in the next issue of ESTATE PLANNING, will discuss the asset protection behind a discretionary trust. Part 3 will examine the protection of a remainder interest by using a dynasty option as well as the control and dominion issues associated with the three common methods for drafting discretionary dynasty trusts. ■