InterActive Legal

Trust Two-Step: Using Trusts for both Non-Tax Reasons and for "Wait and See" Estate Tax Planning

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I. Estate Planning with an Extremely High Federal Estate Tax Exemption

Traditional estate tax planning for a married couple typically involves ensuring the use of the federal estate tax exemption amount of the first spouse to die (referred to herein as the "first decedent") by sheltering that exemption in a trust that is referred to as a credit-shelter trust, estate tax exemption trust, or bypass trust (so-called because it bypasses estate taxation in both spouses' estates). For consistency, this paper will use the term "bypass trust" when referring to a trust that is designed to be funded with the available estate tax exemption of the first decedent.

It can be said that planning for federal estate taxation – and therefore the use of bypass trusts – became the exception rather than the rule when the federal estate tax exemption equivalent rose to $5 million in 2011 and increased further thereafter. This became even more true when the exemption increased due to the Tax Cuts and Jobs Act of 2017 ("TCJA"), as the federal exemption is, as of this writing, a whopping $11.8 million. Because estate taxation became less of a concern for most clients, estate planning itself has taken a different path for many years, with planners finding different ways to add value for clients, since added value does not currently come in the form of demonstrable transfer tax savings. When estate taxes are not the focus, ways to structure bequests to satisfy a client's non-tax goals become more important, along with minimizing income taxation where possible. This can involve using creative trust planning ideas, motivational bequests, and provisions that add flexibility.

Nothing stays the same, however – particularly when it comes to tax laws. Proposed legislation would drop the exemption sharply, likely at the beginning of 2022, meaning today's estate planning clients warrant a different type of flexibility. Much has been written about making lifetime gifts (usually to trusts) to take advantage of the large exemption before it drops, but this article will focus on testamentary planning. How does estate planning change (again) in 2021 and beyond, to address a tax landscape that seems likely to continue to evolve?

II. Desire for "Simple" Wills (and Revocable Trusts)

Shorter, simpler estate planning documents can often make for more satisfied clients. Many married individuals would prefer to simply leave everything to their spouse and kids, with nothing complicated like a trust or any other restrictions. Although there are many advantages of leaving property in trust, and doing so can add tremendous value to a plan, it can be difficult to convince a client to incorporate trusts into an estate plan without a compelling reason to do so. Some reasons – when there are minor children, for example – are obvious. Another obvious reason is when the recommended trust(s) are expected to lower overall taxation. When the tax motivation is absent, or when it is unclear due to a potentially fluctuating exemption amount, convincing clients to use trusts requires that the estate planner become a true counselor and advisor, rather than simply a scrivener. Taking a "wait-and-see" approach to estate tax planning may help bridge the gap between the desired simpler documents and the tax planning that may soon again be the rule, rather than the exception.

While clients may want a simple plan given that taxes aren't an issue, there are several areas where trusts can provide protection and benefits, which we will examine first, before turning to wait-and-see tax planning. For many clients, a more complex plan including trusts is often the better option.

III. Non-Tax Reasons for Trusts

Clients are frequently advised to use trusts in their estate plan for non-tax reasons, because even if clients don't care about taxes, they still care about property. Most clients will likely have a desire to keep property within the family, where possible, and outright gifts to a spouse or to children do not ensure that the property won't be lost to creditors, given away to someone outside the family, or used imprudently. A trust can guard against all of those results. Further, trusts can be structured to reduce overall income taxation in certain situations.

A. Planning for a Surviving Spouse

Understandably, many clients prefer the simplicity of leaving all property to the survivor outright, so that the survivor retains control. This can happen via Wills, where each spouse leaves the residue to the other outright. Or, in states where probate avoidance is a factor, each spouse's Revocable Trust can leave all remaining trust property to the survivor, which the survivor will then add to his or her own Revocable Trust for eventual disposition at his or her death. In community property states, or in situations where the spouses own all (or most) of their property jointly, using one "Joint Revocable Trust" for both spouses' estate plans may be preferred, where the entire trust remains revocable by the survivor.

In all of these cases, the property owned by the first spouse to die becomes subject to disposition by the surviving spouse. The spouse is always free to change his or her estate plan, meaning that the plan agreed upon by both spouses today may not be what actually happens in the future. The spouses may agree today that they will benefit the children equally after the survivor dies, but the survivor will be free to change that plan for not only property owned by the survivor, but also for property that was owned by the first spouse to die.

The only way to ensure that the property owned by the first spouse to die actually ends up in the hands of the children (in the simple example above), is to give the property directly to the children. However, most spouses want to benefit each other, so the better option that allows the spouse to benefit but still have the remaining property pass to the children involves using a trust for the benefit of the surviving spouse until his or her later death. Whatever property remains in the trust at that time passes to the children, without the survivor being able to change that result.

The issue of control may persuade clients to use trusts for each other instead of outright gifts. However, another non-tax benefit of trusts that is likely even more persuasive is the creditor protection a trust affords the survivor. If the survivor has creditors, at least the property interests of the deceased spouse can be protected from those creditors by leaving that property in a properly-drafted trust for the survivor.

Creditor protection is likely the easier benefit to raise with clients. The control issue, while one that most clients would likely say is important, can be difficult to broach, because it can raise the implication of distrust. If both spouses agree today on how they will leave all of their property after the survivor's death, suggesting that the survivor might change the plan could insert conflict into an otherwise harmonious representation. It is arguably easier to raise the topic in a blended family situation, where each spouse wants his or her own property to benefit his or her own descendants, but many blended families may also see no need for the security of a trust. A suggestion here is to raise the issue not exclusively as one of the survivor deliberately changing the plan, but perhaps being pressured into changing the plan (such as by a caregiver exerting undue influence), which a trust should also prevent. Of course, the spouse could be given certain powers over a trust to add flexibility, and cold be pressured into exercising those powers; more on that below.

B. Type of Trust

Once clients are on board with using trusts for each other, the type of trust and the trust's terms must be determined. With the usual goal of making sure the spouse is protected, many clients prefer a trust where all of the income is distributed to the spouse. However, if the spouse doesn't need all of the income, it would arguably be better to allow the income to accumulate in the trust, where it remains protected from creditors. Therefore, the trust used for the benefit of the surviving spouse may be very similar to (if not exactly like) a bypass trust. If the client insists that all income be distributed, then the trust may be very similar to (if not exactly like) a typical marital deduction trust.

C. Trust Provisions to Consider for the Surviving Spouse

1. Discretionary distributions

The spouse can benefit from both the income earned by the trust and its underlying principal/corpus. Income distributions can be mandatory or discretionary; principal distributions, if permitted, are often subject to the trustee's discretion. If the trustee has discretion, the trust will usually include a standard under which distributions are to be made. In situations where the survivor is also serving as trustee, limiting distributions to an ascertainable standard tied to health, education, maintenance, and support is recommended in order to avoid the spouse having a general power of appointment, which could allow creditors to reach the trust property. If a trustee who is otherwise disinterested is named, that trustee could have complete discretion to make (or to *not* make) distributions to the surviving spouse for any purpose.

2. Unitrust provision in lieu of discretion

Discretionary distributions can be troublesome in certain situations, such as blended families where the children from the deceased spouse's first marriage may question every distribution made to the survivor, as each distribution reduces their eventual inheritance. In these situations, and even in situations where there are no step-parents and step-children who may be at odds, a unitrust provision can be a welcome choice. A unitrust provision would direct the trustee to simply distribute a set percentage of the trust's value each year to the surviving spouse – say six percent. The spouse is assured every year of receiving that set percentage, and because the spouse cannot receive more than that, the remaindermen are assured of an eventual inheritance. If the trust assets grow in value, all parties share in that growth, both currently and over time. And if the trust assets decline in value, all parties share in the decline as well.

Unitrust provisions can be included as a minimum level, allowing the trustee to distribute more, subject to a standard, if necessary. This option would place a floor on distributions to the spouse but no ceiling. Another option might be to use the unitrust as a ceiling – providing that the spouse can receive distributions from the trust each year not to exceed the specified unitrust percentage.

Drafting a unitrust provision requires points of reference for when the distributable amount is determined. Trust assets would need to be valued on a specified date each year, often the first business day of the year, or the last business day of the prior year. Including provisions for assets being under or overvalued is also recommended. Additionally, you may want to specify that the unitrust amount for the year is payable in monthly or quarterly installments in order to provide the spouse with a periodic income stream, rather than an annual distribution.

3. Withdrawal rights/lifetime powers of appointment

The overall objective of benefitting the spouse as much as possible, while still protecting property via trust, may prompt the inclusion of specific withdrawal rights or other powers that give the spouse a degree of control. For example, the spouse can be given the power to withdraw a specific amount of property from the trust each year without that power constituting a general power of appointment that would result in loss of creditor protection. Similarly, the spouse can be given a limited lifetime power of appointment to direct distribution of property in the trust to others (within a limited class of permitted appointees, if desired). The inclusion of these powers must be carefully weighed, however, against the reasons for creating the trust in the first place. For example, if a primary objective is to prevent any change in the ultimate recipients of trust property, giving the surviving spouse a power of appointment would be inconsistent with that goal.

4. Testamentary limited powers of appointment

A testamentary power of appointment will also allow the surviving spouse to direct distribution of trust property to others, but only at death (whereas the lifetime power of appointment mentioned in the prior paragraph would allow property to be distributed from the trust to others while the surviving spouse is alive). Testamentary powers are a way to add flexibility to a trust, giving the survivor the power to redirect the trust assets (which otherwise would likely pass equally to children, or per stirpes to descendants) among a specific group.

Permissible appointees can be limited to the descendants of the first decedent, which would be helpful in a blended family situation, where the survivor might have a reason to change the shares, but would still be limited to only benefiting a certain group. Alternatively, permissible appointees might include surviving spouses of descendants, or charities. The class of permitted appointees could be broader, of course, but that necessarily gives the spouse more control than is perhaps desired. For example, the spouse could be given a very broad limited power – to appoint property to anyone other than herself, her creditors, her estate, or the creditors of her estate – which would allow her to essentially redirect the property to anyone – her new husband, his children, her caregiver, her group of friends, etc. – taking the family property outside of the family. Hence, limiting permissible appointees is often a good recommendation.

D. Income tax issues

Depending on how the trust for the spouse is drafted, it may or may not be included in his or her estate at death. In most cases, the trust will not be so included, unless it qualifies for the federal estate tax marital deduction because it is drafted as a qualified terminable property ("QTIP") trust and the QTIP election is made on the estate tax return of the first spouse to die (a return which otherwise may not be required, except to make this election). Estate inclusion may seem irrelevant with the current high estate tax exemption (excluding the reality that it is likely to drop soon, and before the surviving spouse later dies). However, one ***benefit*** of estate inclusion is the step up in income tax basis under Section 1014(e). Property that receives a step up in basis will be subject to less income tax when the property is later sold, so having property included in the spouse's estate may be desirable, if it does not trigger additional estate taxation.

As noted, if the trust qualifies for the marital deduction, it will be included in the survivor's estate automatically and receive a step-up in basis. However, if the trust is set up as a bypass-type trust (where income distributions are not mandatory and others can benefit from the trust during the survivor's lifetime), then the drafter may want to include a separate mechanism to trigger estate inclusion, either automatically or only if specific action is later taken.

One method of including property in the survivor's estate is to give the spouse a general power of appointment which will result in estate inclusion under section 2041 of the Internal Revenue Code (the "Code"). The general power can be narrow in scope – allowing the spouse to appoint property only to the creditors of her estate, for example – so that the spouse is not given the unlimited ability to redirect the trust property, yet still getting the benefit of the step up in basis. The power need not be given automatically; it could be conferred at a later date by a disinterested trustee, allowing the fiduciaries to trigger estate inclusion only if circumstances indicate that it would produce the best overall tax result.

Another option discussed by many commentators after the exemption increased significantly is a formula-based power, which would attach only to appreciated property (where the step-up would have value), and only up to the amount of the available estate tax exemption (so that estate taxation is not triggered in the survivor's estate).

E. Flexibility

Mentioned throughout this outline are a few ways in which flexibility can be added to a trust created for the spouse, such as by including powers of appointment. Another option to consider (if not provided expressly and adequately by state law) is to include a "decanting" provision – allowing a disinterested trustee to create a new trust with similar beneficiaries, to which trust property is poured over. This essentially allows an otherwise irrevocable trust to be governed by new terms, within some limitations, without the need for judicial modification. It is particularly beneficial for long-term trusts, where circumstances unexpectedly change, but also can be useful in a trust for the surviving spouse in a similar situation. In some states, a statutory decanting process may be available if the trust's terms fall within the statute; often, the trustee must have complete discretion to distribute principal for decanting to be an option.

IV. Gifts to Descendants (or Others)

A. Defining "Descendants"

If estate taxes are not a focus, there is more time to consider issues that might not otherwise be discussed – but that can be surprisingly important to many clients. One such issue is whether to include descendants who are adopted. Some clients may have strong feelings about this, and not want property to pass to adopted descendants. However, without an express provision in the document, most (if not all) state laws treat adopted descendants exactly the same as natural-born descendants.

Similarly, clients may want to exclude descendants who at some point are adopted out of the family (such as if a child passes away and the child's surviving spouse remarries and the new spouse adopts the children). Whether to include certain more remote descendants, often grandchildren, may also depend on whether the client maintains a relationship with those descendants. Finally, clients may want to include provisions regarding descendants born through artificial means and advanced reproductive technology. For example, suppose the client's son passes away, but his surviving spouse, many years later, decides to use preserved genetic material to posthumously conceive a child. The client may or may not want to include such a child within the definition of his or her "descendants," depending on the situation.

These issues can be addressed by how the document defines terms such as "children," "grandchildren," and "descendants." They may be issues that the client has never before considered, and having the certainty of addressing them specifically provides added value – even if property is not passing in trust.

B. Outright vs. in Trust

After both spouses have died, the question of leaving property outright versus in trust arises again, this time with respect to children and perhaps future generations of descendants (grandchildren; great-grandchildren). The same benefits of using trusts apply – protection from creditors of the children and the ability to prevent property passing to others outside the family, by not giving the children the ability to give the property away through outright ownership. For children and other descendants, there is another factor as well – one of the least desirable "creditors" a person can have is a future ex-spouse. The idea of family assets being lost in a child's divorce simply because they were left outright to the child (and then comingled) is a great motivator for using trusts for descendants.

If the client rejects the idea of continuing trusts because all of their children are adults and they don't see a need, keep in mind that an unexpected order of deaths could result in property unexpectedly passing to a minor grandchild or more remote descendant. Therefore, drafters should always include a provision with alternative distribution options when the recipient is a minor, just in order to avoid the need for a guardianship/custodianship simply to receive the inheritance.

C. Type of Trust

Trusts for descendants are usually set up in one of two ways: (1) as a single "pot trust" for all descendants, from which distributions can be equal or unequal, or (2) as individual pro-rata trusts, so that each child has a separate trust funded with a proportional amount of the entire estate from inception.

We find pro-rata trusts to be more common, but there are valid reasons for using either structure. In fact, using a pot trust for a specific period, after which the remaining trust property divides into separate pro-rata trusts may be the best option if children are young, as it mimics how the family would have likely treated the children had the parents not passed away. If using pro-rata trusts, the drafter must determine whether the client would like the trusts to continue for each child's entire lifetime – providing the maximum amount of creditor protection available – or if the trust should terminate at a particular age (or in stages, at various ages, such as in thirds at ages 25, 30, and 35, for example).

D. Unitrust Option

As discussed above with respect to the surviving spouse, a unitrust option can be appropriate for descendants as well. This is particularly true if the client wants to benefit his or her children for life, but also ensure that some property is preserved for grandchildren. In this situation, the trust for each child would be established as lifetime trust (i.e., it would not terminate at a particular age), and would pay out the unitrust amount each year to the child, perhaps allowing for additional distributions of principal if a specific need arose. The unitrust amount would equal a stated percentage of the value of the trust assets, perhaps 5% or even 10%, depending on how much growth is anticipated over time, recalculated each year.

E. Decanting

As noted above with respect to the surviving spouse, a decanting provision can allow a trustee to create a new trust and transfer the property of an existing trust into the new trust, with more desirable terms. This allows for some flexibility to address changes in family situation or in tax or trust law, without requiring the time and expense of a judicial modification. A decanting option can be particularly valuable when creating long-term trusts, such as trusts intended to last for each child's entire lifetime.

F. Planning for Special Needs

If a child or other descendant has special needs, leaving his or her share in a supplemental needs trust may be preferred, so that the inheritance does not disqualify the descendant from available government benefits. One advantage of using trusts for descendants in general is that the trust can be set up to adapt to changing circumstances over time. This permits a trust to include a contingent SNT provision that applies if a beneficiary ever becomes eligible for government benefits in the future, where counting the trust as an available resource would affect that eligibility.

G. Letters of Wishes/Precatory Guidance for Trustees

If trusts are incorporated into an estate plan, particularly if the trusts will last for a long period of time, it is often helpful for clients to expressly state their goals and wishes for how the trustee should use the trust property for the benefit of the client's family. Sometimes these goals are set forth in a separate letter to the trustee, referred to as a "letter of wishes." Alternatively, the client's intent could be set forth as a separate precatory provision within the trust agreement itself, providing the trustee with guidance on what factors to consider when administering the trust for the benefit of the client's children and other descendants. An example of such a trustee guidance provision is attached as Appendix A.

H. Substance Abuse

A particular concern of many parents is how to assist children with substance abuse issues, especially those that do not exist today but may arise in the future. If a child is a beneficiary of a trust from which distributions are mandatory, those assets can be lost to the beneficiary's substance habit. If a trust allows discretion, the trustee may be able to withhold distributions, but not in all cases. Including specific provisions to address substance abuse can provide the trustee with more authority to withhold distributions (discretionary or mandatory), while still allowing trust property to be used to pay for treatment and management of a substance abuse problem. An example of such a provision is attached as Appendix B.

I. "Hold-Back" Provision

Substance abuse is not the only reason a trustee may want to withhold a distribution to a beneficiary that would otherwise be required. Perhaps the trustee is aware that a beneficiary has a gambling problem or is under the influence of a third party who might take advantage of the beneficiary. The beneficiary may be in the process of going through a divorce, or the trustee may feel that a beneficiary will not be able to adequately manage a large distribution that is otherwise mandated from the trust for other reasons. A provision allowing the trustee to hold back mandatory distributions can operate similar to the substance abuse provision – allowing the trust to continue for the beneficiary without potential loss of property if it were distributed outright.

J. Marital Property Agreements

As noted earlier, one of the least-desirable potential creditors is a future ex-spouse of a child or grandchild, who might unexpectedly share in the family wealth because it was given to the descendant outright and later comingled. Trusts in general can provide some divorce protection, but clients may want to provide even more security in this regard by incentivizing premarital agreements. The trust agreement can include a provision that completely prevents any distributions (or directs a trustee to severely limit distributions) to beneficiaries who are married but have not entered into a premarital (or post-marital) agreement to protect their property in the event of a divorce. On one hand, this may seem like an overly restrictive provision. However, it also may make it much easier for a descendant to raise the concept of a premarital agreement before marriage, because the descendant can point to the trust as the reason the agreement is ultimately necessary.

K. Estate Inclusion/Basis Step-Up Planning

Income taxes are an inevitability, and if a trust continues for a child's lifetime, there is another opportunity to receive a step-up in tax basis for appreciated trust property at the child's death. This would have the effect of reducing income taxation when the property is later sold, but would only be valuable if it did not increase estate taxation. Therefore, consider the option of allowing a disinterested trustee to confer a general power of appointment on the child, allowing estate inclusion to be triggered if desired, without it being mandatory.

L. Limited Powers of Appointment

As mentioned above in the context of planning for the surviving spouse, limited powers of appointment (both lifetime and testamentary) can add flexibility to an estate plan. For descendants, a testamentary power could allow a child who has no descendants of his own to re-direct his trust to a favorite niece or nephew, or even to charity. The power could be drafted with a specified class of permitted appointees to prevent property from passing outside the family, if desired.

V. Planning for Federal Estate Tax Law Changes

As noted at the outset, we expect the current high federal estate tax exemption to drop to a lower number, perhaps much lower, and perhaps sooner rather than later. What that number may be is unknown – as is when the change might occur. Currently, the exemption is scheduled to return to it's pre-TCJA levels on January 1, 2026 – likely back in the $6 million range. However, current proposals in Congress would reduce the exemption to the $3 million range, likely effective as of January 1, 2022, both of which could change as the legislation is debated. Congress could also take action to make the higher exemption permanent, or even to repeal the federal estate tax again, as occurred in 2010, but those both seem unlikely to occur. Regardless, if the law does change, estate planning documents may need to change, particularly for clients who may find their estates again subject to federal estate tax due to a lower exemption amount.

Not all clients will change their documents in a timely fashion, and if the law does change, there may be an influx of estate planning work such that the demand requires a bit of a wait before changes can be implemented. A prudent plan put into place today should account for these uncertainties, and have a deliberate contingency plan for taking advantage of both spouse's estate tax exemptions, if it becomes necessary.

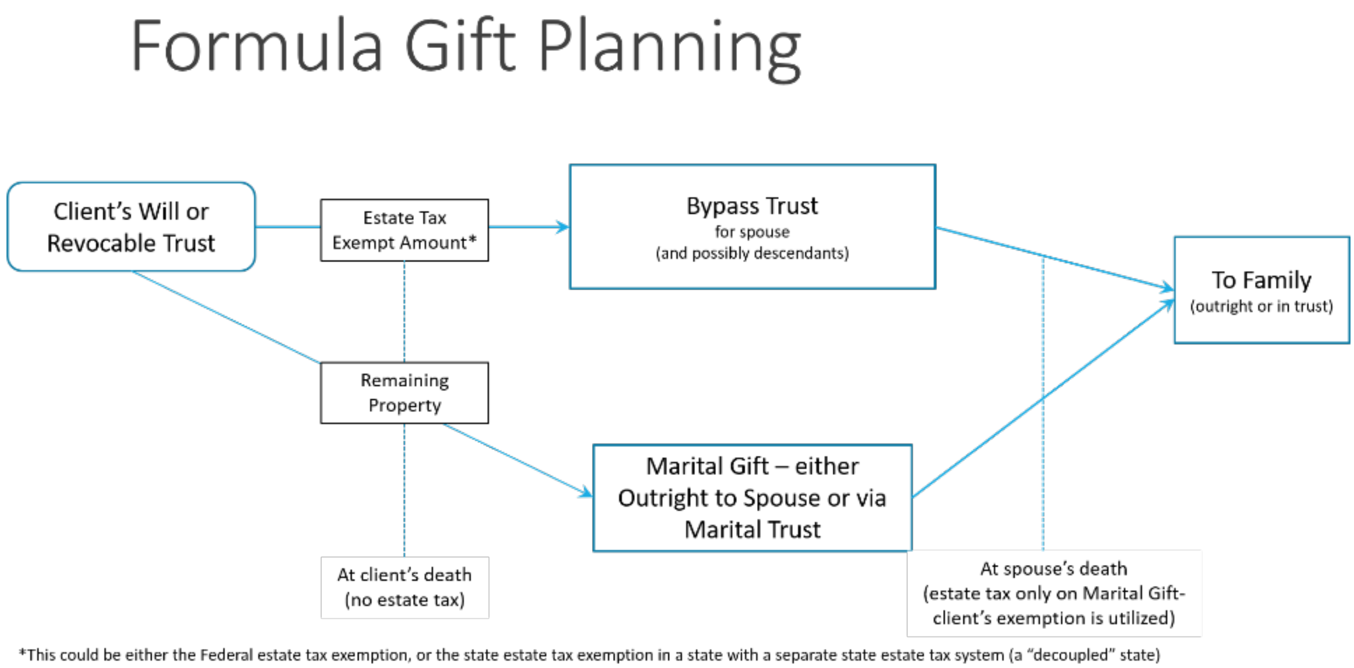
A. Portability

The estate tax exemption of the first spouse to die is now "portable" (see section 2010 of the Code) which provides an automatic contingency plan. However, portability has a number of disadvantages, discussion of which goes beyond the scope of this presentation. We'll focus instead on contingency plans that can be incorporated into the estate planning documents themselves.

B. Formula Gift Planning (Even When it Seems Irrelevant)

In lieu of relying on portability, one option is to keep the traditional estate tax planning we are used to seeing, where the estate is divided into a bypass trust share and a marital deduction share using a word formula (see flowchart below), even if the result of the formula is currently that all property will pass to the bypass trust, i.e., there may not be a resulting gift to the spouse outright or in a marital trust at all.

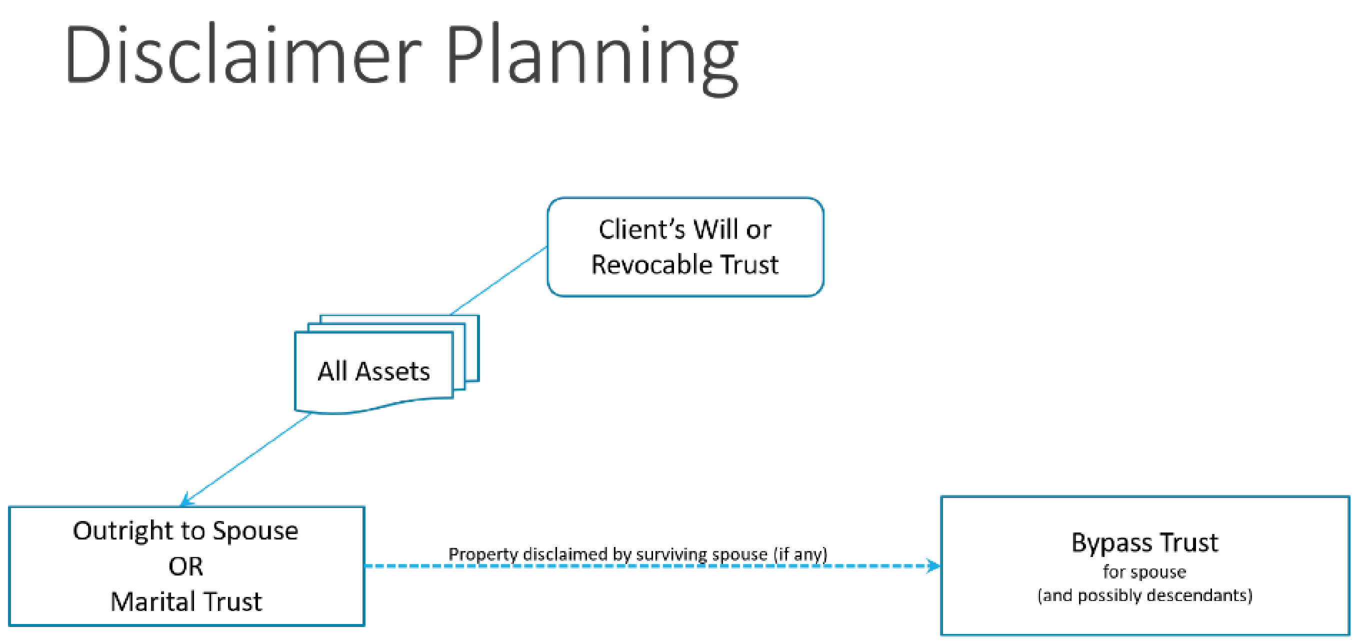
If the client has agreed to leave property in trust for the spouse in any event, then including the formula gift planning may seem superfluous under current law, but if the exemption drops, it would be ideal. Therefore, keeping the traditional formula gift plan may be the best option, particularly because it mandates the result. Other contingency plans, including portability and those discussed further below, require someone to take action after the first decedent dies, while formula-gift based plans ensure that the first decedent's estate tax exemption is fully utilized with no other action required. With a formula-based plan, the client is assured that the best tax result is automatically triggered by their current estate plan, without the need to modify the plan if laws change. Of course, modifying an estate plan if laws change is always recommended, but in the event it cannot be done immediately, the client's estate plan is still in the best possible position.



C. <u>Disclaimer Planning</u>

A common contingency plan for using the first decedent's estate tax exemption is to include a "disclaimer" clause providing that any property over which the surviving spouse makes a "qualified disclaimer" under section 2518 of the Code will not pass to the surviving spouse, or to a marital trust, but will instead pass to a bypass trust (flowchart below). This allows the survivor to consider the situation at the time of the first decedent's death, and fund the bypass trust only if necessary. The bypass trust itself would then pass to family, either outright or in trust, upon the surviving spouse's later death.

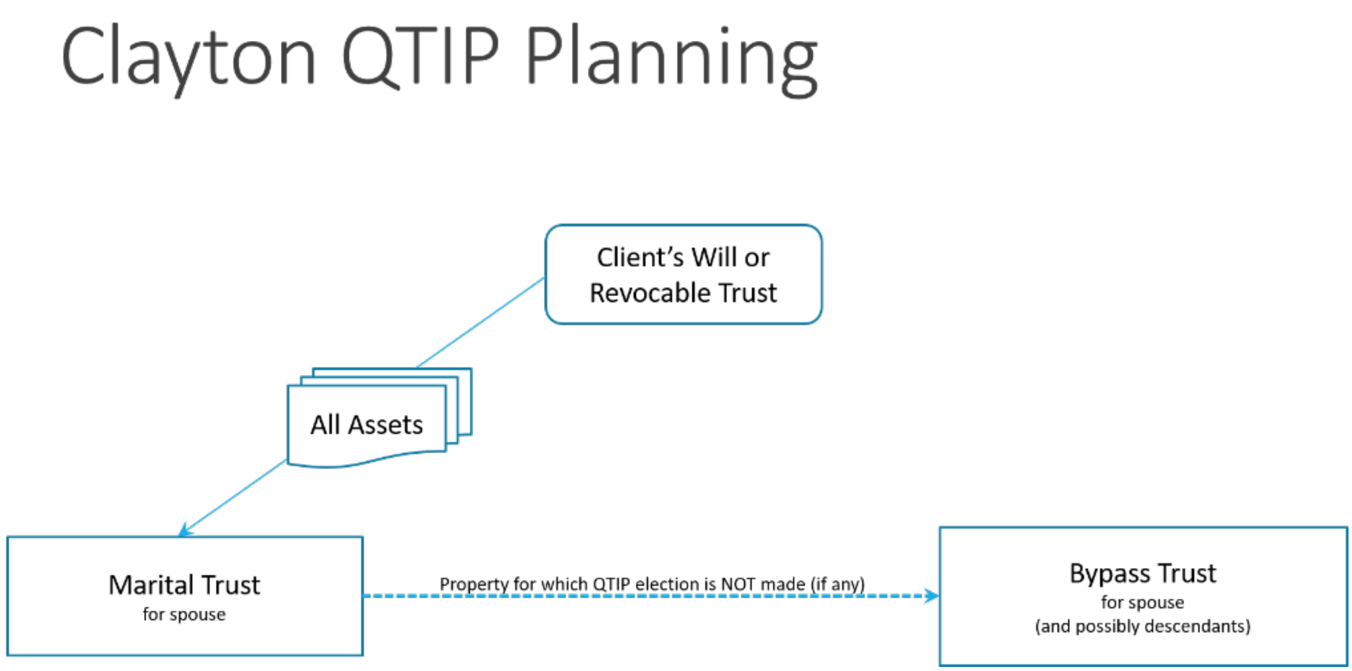
There are both advantages and disadvantages to a disclaimer-based plan, discussed further below. Presumably, the survivor will be advised by legal counsel or an accountant as to the best course of action.



D. Clayton QTIP Planning

A "Clayton QTIP" (named after *Estate of Clayton v. Comm'r.*, 976 F.2d 1486 (5th Cir. 1992)) is a QTIP marital trust that includes a provision directing a different disposition of some or all of the property otherwise passing to the QTIP trust, if the decedent's personal representative does not make the QTIP election with respect to such property. This type of contingent disposition to a QTIP trust is specifically permitted by the Treasury Regulations (See Treas. Reg. 20.2056(b)-7(d)(3)). A Clayton QTIP provides for flexibility in post-death planning, by allowing the personal representative to shift assets out of the QTIP trust in order to achieve certain planning objectives, such as utilizing the decedent's unified credit against federal and/or state estate taxes. For example, a Will may provide for the disposition of the entire estate to a trust for the surviving spouse that is designed to meet the requirements of a QTIP trust, if the QTIP election is made (see flowchart below). The Will may further provide that any property for which the QTIP election is not made shall instead be distributed to a separate trust for the benefit of the surviving spouse and the decedent's descendants. The property that is not subject to the QTIP election will not qualify for the marital deduction, but will instead use a portion of the decedent's remaining estate tax exemption.

A Clayton QTIP plan may be ideal for a married couple with relatively moderate wealth such that they would not be subject to federal estate tax today, given the current exemption level, but who wish to retain the option of preserving the estate tax exemption of the first decedent, without relying on portability, in the event that their wealth increases substantially, or the estate tax exemption changes, before the first decedent's death. The same result could be obtained with a QTIP trust that does not include a Clayton provision, simply by making a partial QTIP election. However, the Clayton provision allows the non-QTIP property to pass to a bypass trust that is more efficient for tax purposes, as it does not require annual payment of income to the surviving spouse, allowing the assets in the trust to continue to grow tax-free, and may allow for distributions to descendants without requiring the surviving spouse to withdraw property from the trust and make taxable gifts to the descendants.



E. Comparing Clayton and Disclaimer Planning

Many attorneys prefer the Clayton plan to the disclaimer plan, for three reasons. First, a disclaimer plan relies on the action of the surviving spouse to make the disclaimer, whereas the Clayton plan puts the power in the hands of the personal representative. Even for couples who do not have descendants from other unions, and who understand the advantage of bypass trust planning, it may be difficult for the surviving spouse to give up the exclusive access to the property provided by an outright gift or a marital trust. In addition, even a surviving spouse who intends to disclaim may inadvertently eliminate the possibility of a qualified disclaimer by accepting the benefits of the first decedent's property. The second reason some attorneys prefer a Clayton provision is the additional time it provides to make a determination as to whether to fund the bypass trust. The QTIP election must be made (or not made) on the Form 706, United States Estate (and Generation-Skipping Transfer Tax Return), which may be filed up to 15 months following the date of death (if a six-month extension is obtained). In contrast, a qualified disclaimer must be made within nine months of the date of death. A final benefit of the Clayton plan over a disclaimer plan is that the latter can be seen as a “transfer” for purposes of Medicaid qualification, triggering the current 5-year look-back period, while the Clayton provision would not be considered a “transfer.”

One potential disadvantage of using a Clayton QTIP is that an independent personal representative should be appointed to determine whether to make (or not make) the QTIP election. This is necessary in order to avoid a potential gift by the surviving spouse, if he or she is acting as personal representative. Another potential disadvantage is that the credit for tax on prior transfers under section 2013 of the Code may not be available on the non-QTIP property if both spouses die in close succession, because the personal representative of the first decedent's estate may not have the option to cause estate tax to be paid on all or a portion of the estate by not making the QTIP election. Notwithstanding these potential disadvantages, it is likely that Clayton QTIP plans will begin to gain popularity given the current federal estate tax exemption, due to the post-death flexibility they provide.

VI. Conclusion

Many estate planners have had to adjust to planning in an environment where federal estate taxes are not a concern, but that should change soon. If/when the exemption returns to a lower amount, most clients who own a home and have invested for retirement will again need to plan for estate taxation, usually by using a bypass trust. Until then, and without that need for a bypass trust, different planning opportunities exist, most of which still include continuing trusts for family members, perhaps for many years. Those trusts can be structured in a number of different ways to address non-tax issues such as blended families, the desire to limit the ability of the surviving spouse or a descendant to direct property to non-family members, creditor protection, and income taxation of trust property. The Appendices include examples of some provisions that can address these issues. Additionally, issues such as how to define one's descendants – when family situations and technology are both resulting in an evolution of the traditional concept of family – may be more important to clients than they realize, and can be addressed in their estate planning documents to provide clarity and certainty.

Although federal estate taxes may not be a concern today, they will likely be relevant for many clients in the coming year or even sooner, before clients have a chance to update their estate planning documents. Therefore, including a contingency plan to take advantage of the available estate tax exemption of the first spouse to die if necessary, is strongly recommended. That way, there can be mechanisms in place to trigger a bypass trust, should it be appropriate under the circumstances.

ARTICLE XIII

Guidance for Trustee

Without in any way limiting the sole and absolute nature of the discretion conferred upon the Trustee, and without imposing any fiduciary duty to do so, it would be in keeping with the Grantors' intention, but it is not the Grantors' direction, that the Trustee consider the Grantors' wishes expressed in this Article, in exercising the discretion to distribute trust property to the Grantors' descendants. The Grantors challenge the beneficiaries to follow the examples of their benefactors by being as self-reliant as possible and not expecting this trust to be a substitute for personal endeavor and achievement, and by being concerned for the following generations as the previous generations have been concerned for them. The Grantors want the beneficiaries to have every opportunity to achieve their potential in life, whether such potential is achieved by pursuing a career in a profession such as medicine, education, or law, a career in business, philanthropy, politics or civil service, or any other endeavor or pursuit, including being a full-time parent, that brings them fulfillment and benefits their community. It is the Grantors' hope, but not the Grantors' direction, that the Trustee will be supportive of those beneficiaries who are worthy by reason of, and to the extent of, such beneficiaries' own demonstrated and actual efforts to achieve their highest potential in life by their own diligence, integrity and industry. However, it is the Grantors' hope, but not the Grantors' direction, that the Trustee consider the special needs of beneficiaries with disabilities or health-related issues that impair those beneficiaries' ability to be independent. The Grantors urge the Trustee to administer any trust created hereunder for the benefit of the Grantors' descendants in a manner consistent with these wishes.

ARTICLE XII
Substance Abuse

The following provisions apply to all trusts created under this Agreement, except as expressly provided to the contrary in this Article entitled "Substance Abuse:"

A. **Dependence.** If the Trustee reasonably believes that: (1) a beneficiary of any trust created under this Agreement (i) routinely or frequently uses or consumes any illegal drugs or other illegal chemical substance so as to be physically or psychologically dependent upon that drug or substance, or (ii) is clinically dependent upon the use or consumption of alcohol or any other legal drug or chemical substance that is not prescribed by a licensed medical doctor or psychiatrist in a current program of treatment supervised by that doctor or psychiatrist; and (2) as a result of such use or consumption, the beneficiary is incapable of caring for himself or herself, or is likely to dissipate the beneficiary's financial resources; then the Trustee must follow the procedures set forth below.

B. **Testing.** The Trustee will request the beneficiary to submit to one or more examinations (including laboratory tests of hair, tissue, or bodily fluids) determined to be appropriate by a licensed medical doctor or psychiatrist selected by the Trustee. The Trustee will request the beneficiary to consent to full disclosure by the examining doctor or facility to the Trustee of the results of all the examinations. The Trustee shall maintain strict confidentiality of those results and will not, without the beneficiary's written permission, disclose those results to any person other than the beneficiary. The Trustee may totally or partially suspend all distributions otherwise required or permitted to be made to that beneficiary until the beneficiary consents to the examination and disclosure to the Trustee.

C. **Treatment.** If, in the opinion of the examining doctor or psychiatrist, the examination indicates current or recent use of a drug or substance as described above, the beneficiary must consult with the examining doctor or psychiatrist to determine an appropriate method of treatment for the beneficiary. Treatment may include counseling or treatment on an in-patient basis in a rehabilitation facility. If the beneficiary consents to the treatment, the Trustee may pay the costs of treatment directly to the provider of those services from the income or principal otherwise authorized or required to be distributed to the beneficiary, if the Trustee otherwise determines that the funds are available to do so and it is in the best interests of the beneficiary to do so.

D. **Mandatory Distributions Suspended.** If the examination indicates current or recent use of a drug or substance as described above, all mandatory distributions and all withdrawal rights from the trust estate with respect to the beneficiary during the beneficiary's lifetime (including distributions upon termination of the trust for reasons other than the death of the beneficiary) will be suspended until:

1. in the case of use or consumption of an illegal drug or illegal substance, examinations indicate no such use; and

2. in all cases of dependence, until the Trustee, in the Trustee's judgment, determines that the beneficiary is fully capable of caring for himself or herself and is no longer likely to dissipate his or her financial resources.

E. **Discretionary Distributions**. While mandatory distributions are suspended, the trust will be administered as a discretionary trust to provide for the beneficiary according to the provisions of the trust providing for discretionary distributions in the Trustee's discretion (other than an Interested Trustee) and those provisions of the trust relating to distributions for the beneficiary's health, education, maintenance or support.

F. **Resumption of Mandatory Distributions and Withdrawals**. When mandatory distributions to and withdrawals by the beneficiary are resumed, the remaining balance, if any, of the mandatory distributions that were suspended shall be distributed to the beneficiary at that time and the balance of any rights of withdrawal by the beneficiary shall be immediately exercisable by the beneficiary. If the beneficiary dies before mandatory distributions or rights of withdrawal are resumed, the remaining balance of the mandatory distributions that were suspended shall be distributed to the alternate beneficiaries of the beneficiary's share as provided herein.

G. **Other Prohibitions During Mandatory Suspension of Benefits**. If mandatory distributions to a beneficiary are suspended as provided above in this Article, then as of such suspension, the beneficiary shall automatically be disqualified from serving, and if applicable shall immediately cease serving, as a Trustee, or in any other capacity in which the beneficiary would serve as, or participate in the removal or appointment of any Trustee hereunder.

H. **Exoneration Provision**. It is not the Grantors' intention to make the Trustee (or any doctor or psychiatrist retained by the Trustee) responsible or liable to anyone for a beneficiary's actions or welfare. The Trustee has no duty to inquire whether a beneficiary uses drugs or other substances. The Trustee (and any doctor or psychiatrist retained by the Trustee) will be indemnified from the trust estate for any liability in exercising the Trustee's judgment and authority under this Article, including any failure to request a beneficiary to submit to medical examination and including a decision to distribute suspended amounts to a beneficiary.

I. **Tax Savings Provisions**. Notwithstanding the provisions of the preceding subparagraphs or any other provision of this Agreement, the Trustee shall not suspend any mandatory distributions required for a trust to qualify, in whole or in part, for any Federal or state marital deduction or charitable deduction or as a qualified subchapter S trust. Additionally, nothing herein shall prevent a distribution mandated by the provisions hereof relating to the Maximum Duration of Trusts.