## **Trusts & Estates Class Notes**

January 13, 2005

Why do we talk about estate taxes in a trusts class?

• Estate taxes drive the world of trusts – you have to be careful about estate tax law when setting up trusts. Trusts have to pay taxes.

# Chapter 6 – The Government's Share – A Brief Introduction to Estate Taxation

What's the point of preventing transmission of wealth to family members?

• Inheritance creates a disincentive for children to productive activity

History of Federal Estate Taxation

- The federal estate tax was introduced in 1916 and targets the wealthy.
  - The idea came from President Teddy Roosevelt and Andrew Carnegie.
    They were very rich. They wanted to prevent the ultra-rich, super-elite
    from running the country.
- In 1931, Congress enacted a gift tax to reduce tax avoidance because wealthy people were giving away their assets before their death.
  - People could still lower their tax liability by giving away their assets during their lives because the gift tax was lower than the estate tax. Also, the gift tax and estate tax each had exemptions.
  - Some wealthy individuals were able to avoid an entire generation of tax by giving to their grandchildren rather than their children.
  - The gift tax made it so that if you gave an inter vivos gift, you would have to claim it as part of your taxable estate.
- In 1976, Congress reformed the estate and gift tax and created a unified credit and a generation-skipping tax.
  - o The unified credit unified the federal estate and gift tax.
  - The generation-skipping tax prevented the wealthy from avoiding a generation of tax by devising property to their remote descendants.
- In 1981, Reagan's tax-cut program reduced the federal estate tax and enacted an unlimited marital deduction.
  - o The unlimited marital deduction allows an estate to be tax-free if it passes entirely to a surviving spouse.
- In 1997, the Taxpayer Relief Act increased the size of estates that pass free of tax. The exemption was made to rise with inflation.
- In 2001, the Economic Growth and Tax Relief Reconciliation Act increased the exemption from estate taxation, reduces the highest marginal tax rate, and abolishes the estate tax altogether for one year only in 2010.

In addition to the federal estate tax, most states have death or inheritance taxes. These vary from state to state.

The Mechanics of the Federal Estate Tax

- The federal estate tax is designed to be a **once-a-generation tax on the transmission of wealth**. It is imposed at death.
- The tax is progressive because of the exclusion. Decedents who die with taxable estates of less than the "exclusion amount" incur no tax liability at all.

# Computing estate tax liability:

Start by computing the tax base – the amount subject to tax.

Includes the taxable estate, together with all taxable gifts made during the decedent's lifetime.

 All property owned by decedent at death is included in the decedent's total gross estate. (see §2033)

- The gross estate includes life insurance proceeds, employee death benefits, and decedent's interest in joint tenancies.
- §2035 to §2044 allow for certain deductions against the gross estate.
  - This includes debts you had at death and allowable expenses, such as administration expenses of your estate, claims people had against your estate, etc.

The total is your <u>taxable estate</u>.

Add any gifts made after December 1976.

o Then, proceed to §2001(c), which gives us the <u>tentative tax</u> on the tax base determined in step 1.

This is your tentative tax.

Then, add in your gift tax due (on inter vivos gifts).

The total is your gross taxable estate.

- Finally, proceed to §2010(a), which instructs us to allow a credit against the tax we have computed in step 2. This is the <u>unified credit</u>.
  - The credit available to a decedent who dies in a given year is precisely equal to the tentative tax that would be due on the "exclusion amount" for that year.

The effect of the credit is to permit an estate equal to the exclusion amount to pass tax-free, and to tax all transfers in excess of that amount at marginal rates.

If a decedent's estate does incur tax liability, decedent will also be entitled to a credit for any gift taxes actually paid during his lifetime. (Form 709 is the gift tax return)

Add on any generation-skipping tax

Equals the TOTAL TAX DUE

# The Annual Gift Exclusion – 26 USC §2503

deals with taxable gifts.

 §2503(e) excludes from tax payments made as tuition to educational institutions and payments made to providers of medical care.

 Note: these payments must be made directly to the medical care providers or educational institutions.

• §2503(b) – in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year, the first \$11,000 of such gifts to such person shall not be ... taxable.

 This was originally \$3,000 in 1981, and then \$10,000. Then the Taxpayer Relief Act of 1997 made it shift with inflation. It now stands at \$11,000.

o Each spouse in a married couple can give it away.

o This amount is tax free as a gift for you and the person you're giving it to.

o This amount is per donee. Example:

Donor gives \$11K each to five different people. None is taxable.

Donor gives \$50K to one person. First \$11K is tax free, the balance is taxable as a gift.

The \$11K annual exclusion is an effective estate planning device.

# Integrating the Gift Tax and Estate Tax

 A donor does not have to file a gift tax return for any gift that qualifies for the \$11,000 annual exclusion or for the tuition and medical care exclusion.

For other gifts, the donor must file a return reporting the taxable gift.

The donor will, however, apply part of the *unified credit* against the gift tax due, and will therefore not be obligated to pay any gift tax until the donor has used up the entire unified credit.

#### Concerns around gifting:

- A significant advantage to lifetime gifts remains in spite of the unification since the amount of gift tax paid in lifetime gifts is excluded from the estate tax base. See example on p. 467.
- However, the advantage does not apply to gifts made within 3 years of death. §2035(b) mandates that gift taxes paid on gifts within 3 years of death be added back into the decedent's estate for purposes of computing the estate tax.
- There is a significant income tax advantage to passing property through one's
  estate rather than by an *inter vivos* gift the "stepped-up basis." The donor's
  cost basis travels with an *inter vivos* gift, but the cost basis of property received
  through the estate is the value of the asset at the time of transfer.

# The Marital Deduction – §2056(a)

- In 1981, Ronald Regan came up with an unlimited marital deduction which allows estates that pass to a surviving spouse to be tax-free.
  - Why? Congress does not require taxation of the husband's estate at his death only to have it taxed again at the wife's death, since the estate tax is supposed to be a tax on transmission of wealth between generations.
  - If you leave everything to your spouse at your death, there are no taxes.
- Couples use the marital deduction in conjunction with the unified credit to take full advantage of both and minimize taxes. See examples 4-5 on p. 469.
- Wealthy couples should make sure that both partners have enough assets to use the unified credit, rather than having all assets in one of the spouses' names.
   See examples 6-7 on p. 470.
  - This can be done by one spouse giving a gift to the other spouse. **Gifts between spouses have no tax consequences.** §2523(a) allows a deduction for the full value of gifts between spouses.

§2513(a) – Each spouse can make use of an \$11,000 gift exclusion –
therefore, a married couple may give \$22,000 per year to each of their children,
grandchildren, or other donees without any tax consequences.

Before the generation-skipping tax was introduced, people tried to beat the government by giving the gifts to grandchildren or other relatives. The government caught on and enacted the **generation-skipping tax** in 1986.

- Any transfer to someone more than one generation away from you (grandchildren or more) or someone 39 years younger than you is considered a <u>direct skip</u> and you must pay generation-skipping taxes on gifts to them.
- There is a generation-skipping tax exclusion.
  - o There's a \$1.1 million lifetime exclusion on generation-skipping tax that is indexed (so can go up). You must claim (elect or choose) it on your 706 return.
  - Example: You want to set up a trust in your lifetime and you've got \$6MM and have kids and grandchildren. What should you do?
    - First put \$1.1MM in a GST trust. You'll use \$1.1 of your election. It uses your unified credit; it grows from the time you set it up until you die tax free. You'll still have to pay capital gains.

Remember: Tax avoidance is illegal - minimization is fine!

What we'll go over this semester:

- Types of trusts:
  - The most common trust we'll talk about (and the most common you'll see) is a <u>family trust</u> where the "applicable exclusion" (or unified credit amount) is used to fund a family trust. You decide who gets it eventually.
  - The next most popular is a <u>marital trust</u>. You put the balance of your estate in it. The property isn't taxable at your death because it goes to your spouse. The assets get a step up when you die, but may or may not get a step up when she dies. Who pays the taxes? Probably her.
  - o Testamentary trust created in a will; very common
  - o Inter vivos trust created during life
  - Simple trusts you have a remainder, but the income must be paid out
  - Complex trusts you have a charitable beneficiary or the income doesn't have to be paid out
  - Dynastic trusts take advantage of the GST Exemption
  - o Qualified Personal Residence Trust (QPRT)
  - o Spendthrift trust no money given to beneficiaries' trust
  - Charitable trusts set up to help a charity
  - o Charitable Lead trusts benefits a charity up front and you get paid at the end.
  - o Charitable Remainder trusts benefits the charity after you've been paid
  - Grantor-retained income trusts
  - o Powers of Appointment

See examples of problems on p. 464 - 472.

## January 20, 2005

#### **QUIZ #1:**

- Must you administer a trust if nominated?
  - No A person can't be forced to be a trustee and may renounce the nomination. However, once you accept, you've got it.
- What is the most fundamental duty the administrator owes the trustee?
  - Duty of Loyalty
- May a trustee delegate his authority?
  - No. A trustee may not delegate his authority. He can hire people, but can't delegate his duty. If the people a trustee hires do something wrong, the trustee's still on the hook but he can sue them.
- Who does a trustee owe the larger duty to remaindermen or income beneficiaries?
  - o Neither trustees must be impartial
- Does a trustee have a duty that he must produce income and to force the principal?
  - o Yes, absent written authority from the trustee.
- What can a trustee do to preserve income?
  - o Insure it against loss, prevent theft as much as possible, pay taxes, and maintain it.
- How often must a trustee produce info to the beneficiary if they ask for it?
  - o On a reasonable occurrence.
- When was the USE developed?
  - 0 1066

## Chapter 7 - Trusts

#### History of trusts:

- Trusts were developed in medieval England began as "use" and came over in 1066. The Normans came over and made changes.
  - o Trusts were not enforced until the 1300s in England.
    - The grantor would say "to A to use for B". This was like a contract.
  - o They enforced them as **contracts** rather than conveyance of property.
  - Trustees had many duties and were on the hook if something went wrong. At the time, a trustee *couldn't be paid* for his services.
- There were no wills in England until <u>1540</u>, when the Statue of Wills was developed.

Before trusts, the property you owned was held in a "bundle of rights theory." You must have possession, management, enjoyment, and disposition of the property to be able to truly say you owned the property.

Trusts are based on a **split title** theory – an **equitable title**, which belongs to the beneficiary, and a **legal title** which belongs to the trustee.

- This came into being after Henry the 8<sup>th</sup> came to power and started changing the courts of equity. Until he changed the equity courts, they were run by the church.
- The **trustee** holds the **legal** title. He has the right to manage the trust property. He has an obligation to manage the property in the *beneficiary's* interest.
- The beneficiary holds the equitable title (aka beneficial title).

# Trusts are a device for the transmission of wealth.

- Trusts came into being because people couldn't devolve their property after their death the way they wanted to. It was a hardship on the people to do dower and curtsy.
- Common uses of trusts:
  - o Trust can be used where the creator of the trust wants to leave property to people with *limited capacity*.
  - o Trusts can increase flexibility in an estate plan.
  - Trusts can be used to reduce tax liability.

#### Testamentary v. Inter vivos:

- Testamentary trusts created by the settlor in a will
- Inter vivos trusts (aka living trusts) created by the settlor while the settlor is still alive

# Notes on Trusts & Legal Life Estates (p. 474):

- One reason that trusts are created is so that the settlor can control property past his own death.
  - Example: Wife wants to provide for both husband and children. She makes a trust that directs the trustee to pay income to the husband throughout his life, and the principal to be distributed to the children when he dies. She could put limitations in the trust language to protect her money if he remarries.
- Why not use just a life estate bequest? Because there are problems that make it advisable not to use legal life estates:
  - Life estates are trouble if some of the property is to be sold neither the life tenant or remaindermen have the right to sell it. It's also questionable who should make repairs, etc.
  - A life tenant can't lease the property for longer than his own life estate. If he does lease it for his life estate time, and he dies before the lease is over, the lessor is in trouble.
  - For these reasons, it's cleaner and easier to use a trust the trustee has
    decision-making power and can sell, lease, and maintain the property as
    needed.

What does it take to create a trust? (p. 475)

- You must have a grantor (aka settlor, testator, etc.)
  - o The grantor must have capacity
  - o Intent Grantor must intend for it to be a trust.
- Property there must be property (aka corpus)
  - o The grantor must have a defeasible interest in property
    - This is the most important
- There must be a beneficiary
- There must be a trustee
  - A trust will not fail for lack of a trustee.
  - o The trustee holds legal title and manages the trust property.
    - Because of this they can do anything with the property legally, it's theirs.
    - If there's a clause that says the trustee can't sell, then it's binding.
  - The trustee is responsible for paying income to the trust beneficiaries.
  - The trustee is a <u>fiduciary</u>, and must sell investments that are no longer prudent. As a fiduciary, the trustee must act in the interests of the beneficiaries, not in the interests of himself.
  - The settlor can define the duties of the trustee in the trust document.

#### QUESTIONS:

- What requirements are most important in the creation of a trust?
  - o The corpus (property), then beneficiary, then grantor, then a trustee.
- What's the very most important requirement for the creation of a trust?
  - o The **corpus** without it, there is no trust!! See *Brainerd v. Commissioner* (p. 485). Expectations of stock gains can't be a corpus.
- If something happens to the trustee, does the trust fail? No.
- Will it fail for lack of property? Yes
- Will it fail for lack of a beneficiary? Not right away.
- How long can you go without a beneficiary? Probably must be within rule of perpetuities, so a long time.
  - The Restatement says that a trust is valid only if it names a beneficiary who is ascertainable at the time of creation or who will become ascertainable during the period measured by the rule against perpetuities.
- What type of entity must a party be to qualify as a beneficiary of a trust?
  - Charity or Business

The rules of trust law apply only when the trust instrument does not supply contrary terms.

# A trust will not fail for lack of a trustee.

- Vacancies in the office of trustee can arise for a number of reasons:
  - o The trust may not name one
  - The named trustee may not fail to qualify, or might die, be removed, or resign.
  - o The trustee might lack legal capacity
- When the trust instrument does not account for these contingencies, a court will appoint a trustee to fill the vacancy and assure continuation of the trust

#### Merger Doctrine

- The same person may not serve as sole beneficiary and sole trustee.
  - O But if there is more than one beneficiary, one or more can be a trustee. And if there is more than one trustee, then one or more can be a beneficiary.
- If something happens so that the only beneficiary is the only trustee, then the legal and equitable titles merge, and the trust terminates.
  - Example: Wife creates trust with husband as trustee. He gets income for life and at death, daughter gets it. Daughter dies and leaves everything to father. He's now the only beneficiary and only trustee, so the trust terminates.

#### Moss v. Axford (p. 479)

- Facts: Mrs. Girard, whose husband predeceased her, left the residue of her estate to Axford, with instructions to give all the residue to the person who, in his opinion, was most worthy by caring for Girard in his declining years. Girard's sisters sued Axford when he gave the residue of her estate to Piers. Piers had cared for Mrs. Girard from the time the will was created until her death. The sisters said that the clause in the trust was a failed attempt at creating a trust, because the beneficiary was not clearly defined. They didn't feel it fair that Axford was given uncontrolled and unrestrained discretion in designating the beneficiary.
- Issue: What happens when a settlor doesn't perfectly describe a beneficiary, but has a beneficiary in mind?
- Holding: A prior case (plaintiffs relied on) held a trust invalid because the
  beneficiary was uncertain. This court held that although the words in her
  residuary clause were precatory, Mrs. Girard's intent in the disposition of the
  residue of her property to the person who should care for her is manifest, and the
  language is mandatory. They said that Axford didn't have unrestrained discretion
  or right to personal opinion, since Girard's intention was unmistakable. She set
  out a test for choosing a beneficiary and he followed it.
- Rule: It is not necessary that a beneficiary be designated by name, or by a description which makes identification automatic, nor that the testator have in mind the particular individual upon whom his bounty may fall. It is enough that the testator uses language which is sufficiently clear to enable the court by extrinsic evidence to identify the beneficiary.

The case also said that a trust is not invalidated by the fact the trustee is vested with discretion.

"to my relatives" is definite enough, but "to my best friends" is not.

Who can be a beneficiary?

- A person, business, etc. even a dog.
- But a dog would be a bad idea that's seen as a <u>memorial trust</u>. A better idea
  would be to give the money to an organization to care for it.
  - Alabama is not big on enforcing memorial trusts.

What is a defeasible interest? One that could be defeated...

### Brainard v. Commissioner (p. 485)

- Facts: This was a review of Brainerd's taxes and the court looked at whether he
  created a valid trust. This involved a stock market scheme. Brainerd
  contemplated trading in the stock market in 1928. He agreed to personally
  assume any losses resulting from the venture, but if his venture was profitable,
  he'd fund the trust for his kids with those future earnings. That is, it was
  contingent on him beating the stock market and was merely speculation.
- Issue: Can you create a trust without a present interest in property?
- Holding: No. The court said that this isn't even a trust it was merely a promise
  to make a trust if he got money. The taxpayer based his declaration of trust upon
  an interest which at that time had not come into existence and in which no one
  had a present interest. Any items of earning would be unrealized (unrecognized)
  gain. The trust failed because it wasn't supported by adequate corpus.
- Rule: An expectancy cannot be the subject matter of a trust. An attempted
  creation, being merely a promise to transfer property in the future, is invalid
  unless supported by consideration. If a person purports to declare himself
  trustee of an interest not in existence, or if he purports to transfer such an
  interest to another in trust, no trust arises even when the interest comes into
  existence in the absence of a manifestation of intention at that time.

#### Standby trusts:

- A standby trust is a trust instrument designed to receive the testator's assets at death, and then to distribute those assets to designated beneficiaries.
  - o Most states now have laws that expressly validate pour-over gifts to standby trusts, even if the standby trust is unfunded prior to the settlor's death.
  - o The trust is funded at the testator's death, and up until the trust is funded, the trustees of the trust have no significant duties.
- Example: You set up a trust that says: "when I die, put this money in a trust."
- No real money is needed to start one, or you can staple a dollar to the paperwork.
- It's recognized as a valid trust and is a great estate-planning tool because it doesn't require any funds to form the trust.
- Questions:
  - o How do you know if you have any money when you die?
    - The language should say to look to a tax form.
  - o How to make the funds go there?
    - Use a pour-over will that says: "put everything I have in the trust."

A settlor must have capacity to create a valid trust.

A settlor's intent is important – it must be more than wishful (precatory) thinking.

## Spicer v. Wright (p. 490)

- Facts: Spicer's will named her sister as "executor," and stated that she left her estate to her sister "to be disposed of as already agreed between us."
- Issue: The question was whether a trust was created or whether the sister was
  to take the entire estate in fee simple (she would own the whole thing).
- Holding: The court stated that the language is <u>precatory</u> (wishful), and the
  extrinsic evidence was insufficient to establish an intent to impose a legal
  obligation of the sister to do something specific with the property.
  - The courts don't approve of semi-secret trusts.
  - They held it to be a <u>void</u> trust because the testator failed to establish the proper intent. She used precatory language. Therefore, the estate goes to the sister outright, not in trust.

#### Levin v. Fisch (p. 492)

- Facts: Bertha Cohen died with a will that said that she left all of her property to her two children (Levin and Cohen) equally. The will said "it is my desire that each year out of the annual rent proceeds ... of the property" that the son and daughter pay \$2400/month to her sister, Laura Fisch. It also said that if she was to marry, then they were to discontinue the payments.
  - o Note: Today, we'd call the sister an income beneficiary)
- Issue: Was Cohen's language ("it is my desire) ambiguous should it be given its ordinary meaning or was it a mandatory instruction to pay the money to her sister each month?
- Holding: The court said that it was their mother's obvious intent that the sister be taken care of. For 2 years prior to her death, Cohen had paid her sister \$200 a month.
- Rule: When determining if particular words are precatory or mandatory, the court will look to the expressed intent of the testator, as found from the context of the will and surrounding circumstances.
  - Words which are generally precatory will only be construed as mandatory if it's evident that such was the testator's intent.

# Things you must have for a trust:

- Grantor must have intent and capacity
- Must have corpus.
- Must have a trustee
- Must have a beneficiary

## How to create an express trust?

• Grantor must communicate (express) his intent to create a trust in very clear terms (written or oral).

# What is an implied trust?

There is an implication of a trust.

# What kind of **formalities** must you take to make the trust valid?

- Grantor must have capacity
- If it contains real estate, the trust must contain all the formalities of a deed
  - o Document must be in writing.
  - o To convey property it must be witnessed by 2 people.
- An express oral trust is sometimes valid.
- Trusts can sometimes be implied but they're hard to enforce. Express trusts are better.
- If over \$500 must be in writing.

# What happens if one of the formalities fails?

- Constructive Trusts not really a trust at all, it's an equitable remedy constructed by the court.
  - o Example: "Look Joe, you have property illegally and the income you earned will now go to the real owner." The real owner is a constructive
  - Under what circumstances does a court use constructive trusts? In cases of unjust enrichment.
- Resulting Trusts settlor had great intent but didn't do everything perfectly.
  - Example: They either didn't execute the document or didn't do it properly.

# You should always have two consecutive trustees in a document.

However, a trust will not fail for lack of a trustee.

#### Are **oral trusts** valid?

Yes. However, trusts for real property and trusts for over \$500 must be in writing.

# Goodman v. Goodman (p. 496) - a constructive trust case

- Facts: Clive Goodman died, survived by his mother (Gladys), and his four children. Before he died, Clive gave his mother general power of attorney and transferred his major asset, Ozzie's Tavern, to Gladys, who sold it and kept the proceeds. Clive's kids sued once they were old enough, claiming that Gladys was supposed to be holding the money in trust for the four kids. Clive's ex-wife and mother of the kids testified that Clive had a will and that his intent was for the kids to get the money. She also said that Gladys herself told her at Clive's funeral that she would "hold the money until [the kids] were old enough to be responsible."
- Issue: "When she thought they were ready" was ambiguous (probably latent ambiguous). And the problem was that the statute of limitations was 3 years.

o They assumed that when they were 18 they'd ask about it. Gladys told their stepmother about it but didn't specify an age.

Holding: The court said it was a question of fact, not of law, since it was ambiguous. They determined that the Gladys held the property in trust for the benefit of the children because that was Clive's intent. Therefore, they said it was an express trust. Though Gladys argued that the statute of limitations had run, the court said no.

Once your client gets on the hook as a trustee, they are on the hook.

What is the standard of care of a trustee?

 The standard of care that every fiduciary trustee is measured against is a <u>prudent person</u> standard.

# One formality of a trust is that the property must be delivered to the trustee.

- What constitutes delivery can vary from state to state. It may include changing the name on a title to "'settlor' as trustee for XXX."
- This is a formality that courts sometimes use to invalidate a trust when they can't find anything else.
- If the settlor is the trustee, no delivery is necessary.

AL §19-3-120.2 - when acting on behalf of a ... shall act with...prudence and diligence under the circumstances...

## **Duties of a Trustee**

- Loyalty (the most fundamental duty of a trustee the trustee can't make money off of the trust or slight it for anyone else's benefit)
  - NOTE: A trustee may denounce the assignment.
- A trustee may not delegate his responsibilities.
- Keep and render accounts.
  - o Fiduciary accounting is not easy. You must keep up with everything that comes in or goes out as principal or income. The trustee must keep up with so that they can produce it for tax returns or whenever asked.
    - That is, they have to know what money coming in is principal and what is income. They have to know which (principal or income) to pay bills out of.
- Furnish information to beneficiaries upon request (but only when reasonable)
- Duty to exercise reasonable care. (Exercise such care and skill that an ordinary prudent man would.) If you have special skills, you're held to a higher standard.
- Take and control the property or assets and taking whatever steps are needed
- Duty to preserve the trust property
  - o Insure it
  - o Prevent theft
  - o Preserve property from damage by third parties
  - o Take care of maintenance
- Duty to make the trust productive unless the beneficiary or trust language says the trustee is not required to make it productive
- Duty to enforce claims.
- **Duty to defend actions**
- Duty to keep trust property separate. If you have several beneficiaries, you must do this.
  - o You cannot mingle trust funds with your own funds
- Where income is payable to the beneficiary, the trustee has a duty to pay.
- Duty to deal with beneficiaries impartially.
- Duty to co-trustees. Where there is more than one trustee, each trustee has the duty to participate in the trust engagement.

#### January 27, 2005

#### Review points from last week:

- Duties of Trustees:
  - The duty of loyalty to the beneficiary is the most basic and important loyalty owed by the trustee. This means that they are loyal to the beneficiary above all others.
  - The standard of care that a trustee owes is the prudent person standard.
  - A trustee may assign tasks to others, but may NOT delegate liabilities or duties.
  - A trustee must keep and render accounts. They must give that info out on request by the beneficiary. The timeframe should be reasonable.
  - o Trustees have a **duty to preserve the trust property**. They do this by insuring the property, maintaining it, etc.
  - Trustees MUST make trust property productive absent instructions otherwise or unless the beneficiary agrees that some of the property may not be productive.
- Do trustees have to pay a beneficiary income?
  - Yes, a trustee has a duty to pay income if they are supposed to get it.
  - o If the trust document says to pay a beneficiary income, the trustee must do so. When? When it's reasonable.
- Absent language in the document otherwise, all beneficiaries must be treated EQUALLY. No favoritism.
- Do trustees owe anything to co-trustees?
  - Yes, a duty of participation. Trustees must allow other trustees to do their job.
- Implied trust
  - Takes little more than a situation where someone gives you property that you know isn't yours and know it isn't yours. Example: "hold Joe's money for me."

## **Avoiding Probate**

#### Why try to avoid probate?

- The only reason to do so is for privacy. That's the only legitimate reason it
  may be a little quicker, and will save you hardly any money at all, so saving costs
  and delays are not really reasons. But a trust is a private document.
  - o What gives you privacy? The private trust document.
  - o Who can view a trust document?
    - Absent a court order, only the grantor (and his lawyer), trustees, and beneficiary can view a trust document.
    - For example, if a rich guy leaves everything to a trust, no one can go down to the probate office and find out what kind of money he had when he dies.

#### Questions:

- Do you save taxes by avoiding probate? No.
- If you avoid probate by putting money into a revocable trust (irrevocable on your death), is it taxed in your estate? Yes.
- Who pays the tax? The trust.

#### **Avoiding Probate Without Using Trusts**

#### "Totten Trusts": Green v. Green (p. 504)

- Facts: George Green died. He was survived by Hilda Green, his wife and plaintiff, and his 3 children from a previous marriage (defendants). During his life, he set up 8 bank accounts and told his daughter how to divide the money. He died intestate because he didn't want anything to be probated. Hilda received \$25,000, but sued the kids for her intestate share.
  - The trial court held that Green intended that upon his death the accounts were to be distributed to the named beneficiaries, and that the trust accounts were valid totten trusts and as such the funds were properly distributed to each of the named beneficiaries.
  - O The court said that a <u>totten trust</u> is a deposit in trust by the settlor of his own money for the benefit of another person. During the settlor's life the settlor may use the funds for his own benefit, but upon his death the trust becomes irrevocable and is the exclusive property of the beneficiary. But the settlor's intent is critical and must be shown through a clear act or declaration made during his lifetime.
- Issue: Was this a totten trust?
- Holding: Yes, affirmed. The court used his intent. They admitted extrinsic evidence to prove intent and called in the daughter. The trust was held valid in Rhode Island. (NOTE: In Alabama, it will be valid as well.)
- Rule: What to get out of this case? You can avoid probate. He was using it for protection of his money.
- You can create an intervivos trust and can put assets in there.
- What does surviving spouse get out of probate estate? His or her share. Here, 1/3 of nothing is nothing. There was nothing going through probate because of how he had set things up.
- Was this a Totten trust (payable on death account)? Yes.

#### **Totten Trusts** in Alabama

- Alabama doesn't like Totten trusts.
- Alabama courts statutorily recognizes totten trusts, however they prefer not to favor them.
- They present a problem because the presumed state of Totten trusts (without language otherwise) is irrevocable. In Alabama, totten trusts are elevated to the position of a regular/real trust. They have status as traditional trusts.
  - o Since March of 1998, they are treated like traditional trusts.

NOTE: Alabama is not a community property state.

In Alabama, **joint accounts** are considered joint tenants with rights of survivorship. This means that when one of the owners dies, the other owns everything, and nothing goes through probate.

The presumption of bank accounts with two names is that they are held as
joint tenants with rights of survivorship.

## <u>Taxable estate</u> – includes pretty much everything

- Probate estate cars, bank accounts, etc. that are in your name alone
- Non-probate estate real estate (unless your will says give your will to a trust and you force your executor to retitle it or unless you put it in your will of how your executor should deal with it), trusts, insurance proceeds (unless it's designated for the trust), JTROS

Real property passes upon death instantly. Who gets it? It passes per stirpes.

Formalities of a deed – legal description, signed by testator, 2 witnesses sign and notarize, etc.

Never title a car in the name of a trust because a car has too much liability with ownership.

#### Westerfeld v. Huckaby

- Facts: Ms. Miller executed two declarations of trust and quitclaim deeds, each
  for one of two lots in Texas, in 1966. She reserved a lot of power over the trusts
  (to mortgage the property, collect rent, amend the trust, change beneficiaries,
  etc.). At her death, the property was to pass to a beneficiary of her husband.
  When this happened, the administrator of her estate (Westerfeld) sued Huckaby
  for possession and title of the lots.
- Issue: Did Ms. Miller create a valid trust even though she reserved in herself broad beneficial rights, as well as the right to revoke the trusts and the right to control or manage the acts of the trustee?
- Holding: Yes, the court found that this was a trust and the property should pass.
   Ms. Miller indicated the intent of her trust, it was in writing, and she specified a corpus, trustee, etc.
- Rule: A trust can be valid even if made inter vivos (during life, without a will).

Upon the grantor's incapacity or death, a revocable trust becomes irrevocable.

- "Pour-over Wills" where a settlor executes an inter vivos trust and then, in his will, puts in a provision that distributes her residuary estate to the trustee of the inter vivos trust
  - Every state has enacted a statute validating will provisions which "pour" assets into inter vivos trusts.

Committee on Professional Ethics v. Barber (p. 540)

- Facts: Baker was an attorney (sole practitioner), and Voegtlin was a certified Financial Planner, who presented seminars on avoiding probate and minimizing estate taxes. Miller was a lawyer and attended one of Voegtlin's seminars and made arrangements to do joint seminars with Voegtlin. They made an arrangement with Baker where Voegtlin and Miller would do a seminar together (both had speaking parts), and then they'd close the seminar by offering free consultations referred to Baker. Baker accepted about 100 such referrals.
- Only Baker was an attorney. The man sending the referrals wasn't an attorney but was getting paid. The court reprimanded Baker for aiding Voegtlin in the unauthorized practice of law and for allowing Voegtlin to direct or regulate Baker's judgment in rendering legal services to Baker's clients.

Does Alabama allow referral fees?

Yes – some attorneys give up to 50%. Many states don't.

February 3, 2005

**Life insurance is never an investment**; it is simply a contract for liquidity. Attorneys should never tell their clients to invest in life insurance.

# Two types of life insurance trusts:

- Funded the entire premium is paid for up front
- Unfunded use annual excludable gifts to pay every year

The whole idea behind life insurance trust is to create liquidity.

- Life insurance trusts are irrevocable.
- Unfunded is probably better than the funded.

**Crummy Trust** – *Crummy v. Commissioner* – Mr. Crummy made a trust where he gave the beneficiaries the opportunity to come in and get the money for a short time each year (30 days). But the beneficiaries knew better than to go get it out.

 The IRS said that this was a completed trust as long as you gave the beneficiaries notice that they could come and get the money out. Therefore, it's a completed gift and there are no taxes. It falls under the annual exclusion.

What do you get with life insurance that you don't get otherwise?

- Liquidity
- It could help cover the expenses of estate taxes because of the liquidity
- It could help protect a small business

#### Detriments of life insurance:

- Fees
- Administrative costs that keep growing
- Life insurance could be accessible by creditors of the estate (unless set up properly in a trust)

How does the rule against perpetuities affect a life insurance trust?

 The rule against perpetuities statute doesn't start to toll on a life insurance trust until the policy matures. That is, the rule doesn't apply to the trust until the policy matures. The policy matures when the insured life dies.

# **Support and Discretionary Trusts:**

- Whether or not it is a support or discretionary trust is built into the document.
- A <u>Support Trust</u> says you need to pay ("shall pay") some person some amount to live on. They are generally mandatory payouts.
- <u>Discretionary Trust</u> is left to the discretion of the trustee as to how much to pay. It can be either **absolute discretion** or **ascertainable standards**.
  - Ascertainable standards stated by the IRS are support, maintenance, health, or education.
  - An ascertainable standard will effectively negate a general power of appointment.
  - o If the trust says "the trustee may in his discretion pay out funds to the beneficiary for the following...", then it is discretionary.
  - Sole absolute discretion = anything they want, as much as he feels necessary
  - The absolute and sole discretion gives your beneficiary more protection from the IRS (taxes), creditors, child support, and divorce settlements. It also protects the beneficiaries from themselves.
  - Benefits to an absolute sole discretion trust:
    - Very flexible
    - If it's a "common pot" trust (several beneficiaries that all take from the same pot), then it's good to allow the trustee to make decisions as to what beneficiary gets what amount. Ex: that way the brain surgeon child gets less than the brain damaged child.
      - Aka "spray or sprinkle" trust sprinkle the assets, and they don't necessarily fall equally.
  - o How do you invoke a discretionary trust?
    - Language: the trustee may, in his sole discretion, give as much or as little as he sees fit....
  - o How do you invoke a limited discretion trust?
    - Language: the trustee may in their discretion pay limited to...
  - With a simple (common pot) trust, you can treat income and principal differently. You can use ascertainable standards when distributing income, but absolute discretion when distributing principle.

# Two types of investments:

- Equity you own stock (part of the company)
  - Some stocks don't pay dividends, some do. That is almost always ordinary income. Stock owners have rights to
  - Equities can grow (a capital gain). You don't pay taxes on growth until sold (unrealized gain).
- Fixed income (bonds)
  - o Buying a bond is buying a piece of a company's debt and collecting income on it.

When you set up a trust, you have to decide whether to set up a support or discretionary trust. The best thing to do is to look at your beneficiary – do they need support? If so, you may want to do a support trust.

Ex: Trust for 85-year old grandmother – you'd probably want to do about 80% bonds and 20% equity.

 Ex: A 20-year old may be different – 80% equity and 20% bonds. That way, he's set up to grow.

The most common trusts are Family trusts and Marital Trusts

- <u>Family trusts</u> are generally funded with your excludable amount ("applicable exclusion") from estate taxes.
  - It is funded from your estate and you wouldn't want to set a specific amount of money, because you don't know how much you'll die with.
  - Fractional funding formula "use that fraction of my estate that would be the amount that would pass with out taxes."
  - Pecuniary funding formula funded by a dollar amount that would be excludable.
    - Pros & cons -
      - Fractional the growth is shared equally
  - o In a family trust, the grantor picks the beneficiaries.
  - Purpose of family trust funded to protect the family
  - o Who gets the money in a family trust? Who you picked

#### Marital trusts

- o Who gets the money? Surviving spouse.
- o In a marital trust, the surviving spouse picks the beneficiaries.
- The entire income must be paid out for it to count as a marital trust
  - One exception QTIP Election (Qualified Terminal Interest Property Trust) giving spouse a terminal interest in property (terminates at death)
    - Grantor says who beneficiary is.
- Unlimited deduction ... no taxes
- Two types of marital trusts:
  - Standard in surviving spouses estate, they have income and can invade it
    - Income must be paid out at least annually
    - Surviving spouse must have right of appointment.
  - QTIP they still have to get the income, but ...
    - Sometimes called the 'second wife' trust

#### Spendthrift trust

- Protects the beneficiaries from themselves
- The grantor may give a beneficiary the power to invade or for the trustee to give them what they need, but they can't anticipate their interest in the trust, alienate their interest in the trust, or mortgage their interest in the trust.
- Ex: you give child \$2M in a trust. If it's not a spendthrift trust, the beneficiary could assign his distribution to a car dealer as collateral on a car. If they did that enough and didn't pay, then there would be no trust left. With a spendthrift provision, the kid couldn't do that.

 Alabama Spendthrift provision says that they can't anticipate their interest in the trust, alienate their interest in the trust, or mortgage their interest in the trust.

#### Howard v. Spragins (Alabama case) - 350 so 2d 318

- It's public policy to protect those kids who can't protect themselves.
- They can not get alimony in gross because it's a property settlement.
- Periodic alimony maybe. They may be able to attach to income.
- You can get child support money.

Child support and spendthrift provisions don't play well together.

What about a support provision when it comes to periodic alimony?

 Yes. If you have to pay the income to the beneficiary, it is subject to periodic alimony attachment.

#### Wilcox v. Gentry (p. 566)

- Frank Gentry created a revocable trust. During his lifetime he was the beneficiary, and upon his death, he gave it to 4 people. A 5<sup>th</sup> share was left open.
- During his lifetime, the trust didn't offer him protection from any child support.
   During his lifetime, he had no protection from alimony in gross. As a grantor, you have no protection during your lifetime with a revocable trust.
- Here, he was lucky because he died.
- Child 5's money was in trust until the beneficiary died (her lifetime). Could she
  ever get any money from the trust? Yes. The trustee had discretionary powers
  to give her money. He gave her money for support.
- She had a lot of outstanding debt. The creditors tried to get the money in her trust to pay her debts. Court said once you pay her money, the creditors can get it.
- This was a discretionary trust, so she can only be on the hook for the amount of money the trustee gave her or will give her. If he gives her no money, they're out of luck.

## Bacardi v. White (p. 577)

- Ms. Bacardi was married for 2 years to Mr. Bacardi. In their divorce, Mr. Bacardi agreed to pay her \$2K per month until one of them died. He didn't, and she tried to attach the back alimony payments to the spendthrift trust.
- The Supreme Court came in and said it was in the best interests to do it and allowed it.

No class next week.

February 17, 2005

# For income tax purposes, trusts are taxed at the highest personal tax rate bracket possible (27.8%).

Therefore, trusts are not a good way to save on taxes.

What happens when a trust and estate has income? It must file a Form 1041 – for trusts and estates. Use calendar year if a trust, but estates can choose a calendar year or fiscal year.

**Inter vivos trusts are created during the grantor's lifetime.** There are two types of inter vivos (grantor) trusts:

- Revocable
- Irrevocable

A revocable life insurance trust doesn't give the grantor any estate or income tax benefits. All income from a grantor trust is taxed back to the grantor at the grantor's level.

If it is a complete irrevocable trust (non-grantor trust) and the income is supposed to be going to someone *other than the grantor* and it can never go back to the grantor, the entire tax goes back to the trust or to beneficiary (if received). That is, if the grantor has no control over the trust, the trust or the beneficiaries may pay the tax.

Irrevocable trust – set up by father with beneficiary of daughter 100,000 (taxable is 100,000 minus 11,000(annual gift)); all income passed out of the trust should be taxed to the beneficiary.

All income coming out of an irrevocable trust is taxed back to the beneficiary

To the extent...in excess of the annual excludable gift, what does the grantor have to do? How much is taxable for gift taxes? It's irrevocable and his daughter is the beneficiary.

File form 709 – Gift Tax Return – you can either pay now (don't do it!), or file it and say you're going to include it on the decedent's gift tax return.

All income passed out or distributed of the irrevocable trust should be taxed to the beneficiary.

So if you pass out capital gains, you pay the capital gains rate. Income tax retains the same character inside and outside the trust.

#### **Crummy Trusts**

- In order for it to be a completed gift, it has to be a present interest.
- Example: grantor is giving an annual exclusion amount to the trust and tells his beneficiaries that they have 30 days to get their money out. The beneficiary must have notice of the opportunity, or this crummy power fails.
- Crummy powers you give it to someone but really want them to hold it and save it, so you throw in a Crummy power where you let them go get it out once a year for a short time.

What does the government look for? Notice – if there's no notice that the money
was there and they could get it, then there's no crummy trust

You may give a minor a gift of up to \$10k in a trust. You can only hold it until they're 19 years old. The uniform trusts for minors act says you can give a gift that's excludable to a minor, but at majority you have to give it to them.

Crummy trusts are considered a gift of a present interest because they have a window to go get it. They qualify for the annual exclusion.

Marital deduction trust (aka marital share trust)

- Any transfer to a spouse is a non-taxable event, whether they are dead or alive.
- Therefore, when most people set up trusts, they use a pecuniary amount to set up a family trust, and leave anything left over to the marital share trust.
- So a person creates a family trust, and then anything left goes into a marital share trust.
- What does it take for a trust to qualify as a marital share trust? The spouse must have access to the entire net income at least annually during his lifetime, and power to appoint the principal OR they have to have the ability to invade the principal.
- You can set up terms for invasion ("they can invade up to XXX%").
- A 5x5 invasion says that the spouse can invade the trust up to 5,000 or 5% of trust.

What happens when surviving spouse dies? It goes into their estate and comes back on them.

Another marital deduction trust is a QTIP (Qualified Terminable Interest Property) Trust

 Who gets the money? grantor gets to decide who gets the money. Surviving spouse get the entire net income at least annually during their lifetime, counted in surviving spouse's estate for estate tax purposes.

To the extent that the trust creates estate tax issue to surviving spouse, the trust should pay the tax.

Any tax liability created for the surviving spouse must be paid by the trust.

## Direct skip person

- Your surviving spouse is never a direct skip person and you can leave money to a spouse with no tax consequences.
- If you give money to someone who is more than one generation younger than you or who is 39 ½ (37 ½ ??) years younger than you, it's considered a direct skip person, and there is a generation-skipping tax.
- There's a generation-skipping exemption of 1.1 million this year.
- Use a generation-skipping transfer tax exempt trust Ex: inside the family trust, give the grandchildren with surviving parents to have use of this trust. The first 1.1 million to them. The other 400k which is generation-skipping-tax nonexempt, to my children (because they aren't skip people).
- As long as money goes to a non-skip person, you don't have to worry, there will be no generation-skipping tax.
- Generation-skipping tax is about 50% on top of other tax.

Inclusion ratio of 1 or 0.

If 1, go to a non-skip person.

Divide GST exemption so that there's one trust that's exempt, and one GST trust that's non-exempt.

#### Accumulation trust

- In Alabama, AL Code §35-4-252 tells you that a trust for the sole purpose of accumulating wealth (that cannot be passed out) cannot last longer than 10 years.
- If the sole purpose is to accrue wealth and grow money and you can't pass it out ever, the longest it can go is 10 years.
- But if you make it where the trustee may at his discretion pass it out, you have a
  discretionary trust (not an accumulation trust), and it can go longer.

If you're a beneficiary of a terminable interest, you get to use it while you're alive, and what you get out is income taxable...

February 24, 2005

Know where liability for income tax lies.

GST exemption example

Guy dies with 40 million. He has a spouse.

The first 1.5 million can go to a family trust. That's how much you can pass without any estate taxes at all.

(In family trust, put 1.1 mil in a Generation Skipping Tax Exempt Trust, put .4 mil in non-exempt GST Trust)

The remainder can go to a marital trust (38.5 million), so that if the wife remarries, the new husband can't get it.

So far no taxes because of the spousal transfer.

There are lots of children and grandchildren.

There's a possibility that a grandchild can take from the trust. A grandchild whose parent survived the testator is a direct skip person because a generation is skipped. However, if the child of the testator predeceases, then the grandchild (the child of the dead person's dead child) gets a step up in generation.

The GST tax is in addition to the estate tax, but there is a 1.1 million generation-skipping exemption. So, you have 1.5 million in a family trust and you know that a direct-skip person may get to that money. Therefore, you make 1.1 million of it go to a GST-exempt trust (that's part of the family trust). The other .4 million goes to a non-exempt one. You want to give money to the children from the non-exempt trust, since children have no generation skipped, and there are no GST issues.

Inclusion ratio - you want it to be either zero or one.

If you don't bifurcate the family trust into GST-exempt and non-GST-exempt, every dollar that comes out of the family trust has a GST consequence.

37.5 years younger and you become a skipped person automatically.

Any transfer between spouses is a non-taxable event. Dad could set up two trusts – one in her name and one in his. Then both could set up a \$1.5 million trust in the scenario above.

Marital deduction trusts – there's a set of things you have to qualify – the spouse must get all the net income at least annually.

If you gave the surviving spouse the power of appointment, then it would be hard to lose the marital deduction.

#### Character of income

- DNI distributable net income give all to mom at least annually every time
  there was income you'd have to distribute it. DNI retains the same character to
  the beneficiary as it did in the trust.
- Ex: you transfer capital gains, the trust pays at the same capital gain rate
- DNI means that the income retains the same character it had in the trust when distributed to the beneficiary.

For every trust you want to remain amendable and revocable- have provision that says p.630

Grantor is trustee and is the only beneficiary it is implied that it is revocable.

3/9/2006

# **Modification or Termination of Trusts**

There are a couple of ways to do it.

Via actions of the grantor -

- What is the default setting for all trusts set up in AL absent language otherwise?
   Irrevocable.
- Can the grantor modify or terminate it? No.

If the grantor sets up a trust and they are the trustee and only beneficiary, it's implied that it's revocable. In that case, there's a merger of titles (legal and equitable).

Otherwise, if the grantor is not the trustee, it's irrevocable.

How much protection does the grantor get on his trust? None in Alabama – some states have "Delaware trusts" where you can protect your money.

Scenario: The grantor is party #1, and trustee is party #2, and you have 2 beneficiaries.

Beneficiaries must be competent.

If everyone is in agreement, trusts can be changed – but all parties must consent. No matter whether it's revocable or irrevocable.

If the settlor is deceased and all beneficiaries agree to terminate the trust, they can go to court to have it done. It's difficult to break an irrevocable trust where a party is deceased, even if everyone else consents.

But if the beneficiaries transfer their interest to the trustee, then there's a merger
of titles. That's a way around the system to terminate the trust where the grantor
is dead.

Alabama doesn't believe in the scheme of early termination of a trust just because they want to. Alabama courts are hesitant to terminate a trust where all parties agree but the grantor is dead. They figure it was the grantor's money and they should honor his desires.

What if beneficiary #1 and #2 hate each other and there is no consent – can you still get things done? Sometimes – if the grantor made a mistake in the set up of the trust. You would go to circuit court.

What if a trust is impracticable – it's impracticable to achieve the purpose of the trust? You can petition for modification.

Sometimes in adverse conditions, where the needs and conditions of a beneficiary trust have arisen, it can be modified.

If it is a private trust (not charitable) – change through the doctrine of equitable approximation.

Generally they won't change the dispositive provisions (to dispose of assets) – they don't like to change that aspect of the trust. But they may change the administrative provisions.

Doctrine of equitable approximation – when the court has to go in and make changes. They are hesitant to change who gets what.

#### Termination by operation of law

- If a trust is set up for a future occurrence of a particular event for example an
  escrow account for a home purchase when the event happens, the trust is
  over. For example, when the home is purchased, the trust goes away.
- Example: you get to closing and the paperwork isn't ready your money stays in trust until they give the money back to you or you complete the transfer.

#### Merger of title

- Alabama law says if you merge the equitable and legal title and the same person holds both titles, the trust if terminated.
- If you have a multiple of trustees and beneficiaries that's not a full merger. Ex: There are two trustees and one is a beneficiary. Or, you have two beneficiaries and one is a trustee but not the other.

Or, what if it was at one time legal to have a brothel and it's later made illegal and while it was legal you made a trust to benefit it. A trust where the purpose of the trust is illegal is terminated. It would be a resulting trust until you figure out who should get the money.

A <u>constructive trust</u> is an equitable remedy.

Next week: charitable trusts

#### **Charitable Trusts**

Does a charitable trust save you tax money? No, it doesn't save you money. Put them in there because they are charitably inclined. Federal tax status- charitable exemptions

Can't hold property- if the charity is not incorporated

Is there a time frame to make a charitable gift for tax purposes? No, can be done up until you die or can be done through your will.

Charitable Trusts – goes to the benefit of charitable purposes. They are recognized by the state.

- <u>Complex trusts</u> different beneficiaries for principal/income or present/remaindermen; or any beneficiary is a charity
- <u>Simple trusts</u> all income goes out, it's never accumulated; no charity is involved.

You must go through all the same formalities as when creating any other trusts – intent, corpus, trustee, beneficiary.

Property rights vest upon being conceived

The Rule Against Perpetuities doesn't affect charitable trusts. As long as it vests in the charity in the amount of time.......if it will never there is a problem.

Henderson v. Troy Bank & Trust (34 So. 2nd 835)

Henderson left some money in trust, and gave the income to some individuals for life, then the remainder to some charities.

Issue: Was the RAP violated?

Holding: No. The RAP doesn't apply to charitable trusts.

Baxley v. Birmingham Trust National (334 So. 2<sup>nd</sup> 848) – who enforces a charitable trust?

Allen died leaving a life estate to his wife, and the remainder in a marital trust. When she died, she had a power of appointment and she wanted to give it to the Allen Bryant Education Foundation, to a law firm, and some missionaries.

At issue was whether Mrs. Allen exercised the power of appointment to pass under his will. That is, did it pass as part of her will or his will? The folks left under his will could've gotten the money if she didn't appoint it.

What happened? The circuit court said that the property was his property and her transfer wasn't effective. The Attorney General sued.

The Attorney General enforces a charitable trust.

The attorney general enforces charitable trusts in Alabama.

You must be very specific when exercising a power of appointment, you need to be very sure to reference the power and the document that created it so that there is no question as to whether a power of appointment was exercised or not.

What happens if you have a charitable trust and you don't like the way it's going and you want to modify it?

- You can change a private trust by consent but you can't change a charitable trust by consent.
- The Cy Pres doctrine is used to change a charitable trust it can only modify/change a charitable trust. Judicial approximation is a method for changing other trusts.
- There is a three-prong test to determine if judges want to use the cy pres doctrine;
  - o It must be a charitable trust. The court must identify the charitable intent.
  - o It must not be impossible, impracticable, or illegal for the trust to achieve its purpose.
  - o There must be general charitable intent.
    - "I want my money to go to the Birmingham chapter of the American Red Cross" is not general. "The Red Cross" is more general.

When does cy pres not work?

If any of these are present the court would probably not use the cy pres doctrine:

- they stated a specific use for the money (the donor had specific charitable intent)
- the donor set up "catchalls" (he anticipated failure of the gift)
- the donor created contingent disposition of the money

Alabama does not like to use cy pres – it is disfavored because they feel like they're changing the intent of the donor. However, it has been adopted and used. The courts think the doctrine is too heavy-handed.

Next week: Powers of Appointment Future Interests March 10, 2005

Does a charitable trust save you tax money? No.

o If you do it, make sure that the person in it is charitably-inclined.

Charitable purposes are generally driven by federal tax status (501c3). Alabama has a more vague description. Something can be charitable in Alabama without having a 501c3 status.

Why is it a problem if a charity isn't incorporated? Because they can't hold title to property.

Is there a time frame for making charitable gifts? No, you can do it up until the day you die, or in your will.

Inter vivos trust – a trust set up during life of the grantor.

Testamentary provision – provisions that aren't effective until after the death of the grantor

In Alabama, there are two other types of trusts:

Complex – when you have more than one beneficiary and you may accumulate income; or, one of the beneficiaries is charitable.

Simple – one where you cannot accumulate income, and there is no charity in the mix.

no differences in making a charitable trust (than a private trust) other than a charitable purpose – still have to have corpus, intent, trustee, beneficiary

RAP doesn't affect charitable trusts. It must or must not vest within the life in being plus 21 years – so it must vest in the charity in that time, and then it can go on forever.

Enforcement of charitable trusts – done by the Attorney General.

Cy pres doctrine – use it only to modify charitable trusts.

There was a 3-prong test to determine if the court may use cy pres:

- Must identify a charitable intent (charitable purpose)
- Must have become impractical or impossible for the trust to achieve its purpose
- It must have been a general intent

There are reasons when you cannot use cy pres doctrine

- If the donor had specific charitable intent; OR
- Donor might have anticipated a failure of the gift; OR
- Donor might have provided contingent disposition of the gifts upon failure of the gift. (If the donor set up "catchalls").

Alabama doesn't like to create intent, so they don't like to use the cy pres doctrine. However, there's a statute that says it can be used.

3/23/2004

# POWER OF APPOINTMENT

Why give someone a power of appointment?

The most common reasons are flexibility in estate planning and also because you can use tax advantages by doing so. (cont see future)

Tax advantage - give a spouse power of appointment over the assets in a marital trust.

Parties involved in a POA

POA-power that authorizes done to designate receipients of the appointed property Donor (grantor) - the person granting the power/creating the power

Donee - the beneficiary of the power of appointment; exercises The power

Objects of the power/class of permissible beneficiary/class of appointees/permissible appointees – a contingent group of appointments

Actual appointees – gets the property

There are several types of power of appointments: Most commonly seen in a trust (usually testamentary)

• I) General power of appointment – anything and everything;

o It immediately moves the assets to be appointed to the donee's estate.

o If the donee or the donee's estate or creditors can benefit from the power, it's a general power.

o Make sure you qualify for the marital deduction - If you don't give all income of a trust to the surviving spouse, you could end up with both the donor and donee's estates being taxed.

Limited power of appointment –

Example: "X may give \$4,000 for any reason he feels like it."

o Use in Family Trusts

Testamentary is most common, but can also be inter vivos. If testamentary, can only exercise it with a properly-referenced will.

Intervivos power - can be exercised during life Testamentary power - must be exercised after death

How do you create a power of appointment and make it work?

Must be in writing

Must have specific references back to the document creating the power (such as if it was created by a will). Leave no question as to which power you're exercising and which document you're referencing, or it won't qualify.

General – in donee's estate Special - in donor's estate

#### Power to Invade

How is it different from a power of appointment? You can limit a power to invade to ascertainable standards or mathematical computations. If it's limited to health, education, support or maintenance then it is not a general power of appointment even though the surviving spouse will benefit or can invade

Ex: You have a family trust and marital trust. Your estate is small. Give the surviving spouse the power to invade the trust limited to ascertainable standards (health, education, maintenance, or support).

If it is not limited as to health, education, maintenance, or support, it's a general power.

March 17, 2005

757-818 for next week

Introduction to Future Interests:

Present interest- becomes beneficial and possessory to the beneficiary at its creation

**Future Interest** - doesn't become beneficial or possessory at creation it may depend on a contingency or never become posessory

expectation for a hope for a beneficiary

Types of future interests:

- 1. Those held by the grantor- limits what type of future interest it can be because the grantor is keeping it themselves
  - possibility of reverter/determinable interest
    - i. A conveys Blackacre to B and her heirs so long as the premises are used for residential purposes. B's fee interest will terminate automatically if and when Blackacre ceases to be used for residential purposes. As a result, B has a fee simple determinable. A holds a possibility of reverter.
    - ii. A conveys Blackacre to B and her heirs, but if the property is used for nonresidential purposes. A may enter and terminate B's estate. Because A may elect to terminate B's interest if the land is used for nonresidential purposes. B has a fee simple subject to condition subsequent; A has a right of entry.

For estate planning purposes do we ever use right of reverter or right of reentry- no because it doesn't do you any good because it keeps it in your estate

- Reversion: To B for life. When B dies it reverts back to the grantor.
- 2. Future interest held by the beneficiary:
  - Remainder
    - i. Vested- if there is an ascertainable person who is the remainderman it is vested
    - ii. Contingent- no ascertainable person who it is vested in it is contingent

To T for benefit of A for A's life, then to B= indefeasibly vested remainder

Vested remainder subject to open or partial defeasment= To T for benefit of A for A's life, then to A's children.

Vested remainder subject to complete defeasence or subject to condition subsequent= To A for life, remainder to B, but if B fails to survive A then to C.

Contingent remainder- either the remainder has not been born or

To A then her children.- contingent b/c children have to be born or having children

To A for life, remainder to B if B survives A, otherwise to C. (contingent)

#### Executory Interest

- 1. To A for life, remainder to B, but if B fails to survive A, then remainder to C. (c has executory interest because it's following a vested remainder subject to complete defeasence.)
- 2. To A for life, and one year after A's death, I direct BA to pass to B.
- To A for life, remainder to B if he survives A, otherwise to C. B has a contingent remainder, C also has a contingent remainder.

March 24, 2005

Last week:

Classified interests between present and future interests
Future interest does not become possessory until some time in the future

#### 2 types of future interests

- Grantor-owned not used much in estate planning; they're useless for estate planning
  - Possibility of reverter automatic; to B and heirs so long as used for residential purposes.
    - Automatically reverts.
  - o Right of entry/re-entry generally says may come in.
    - If not used for residential purposes, the grantor has right to come in and re-enter.
  - Reversion it lasts a specific period of time, or upon a specific event it comes back to the grantor.
    - Example: to B for life. Grantor gets it back when B dies.
- Interests held by donee or beneficiaries
  - o Vested you know who has the interest. Three types:
    - Indefeasibly vested remainder
      - Outright to B
    - Vested remainders subject to open (aka partial defeasance)
      - Ex: to A for life then As children the more children A has, the less they get.
    - Vested remainder subject to complete defeasance
      - Very technical
      - The only difference between it and the contingent remainder is where you put the comma.
        - This one uses: "To A for life remainder to B, if B survives A, otherwise to C." it's vested.
  - o Contingent you don't know who has the interest until it vests
    - Ex: To A for life, then her children.

Difference between vested remainder subject to complete defeasance and a contingent remainder:

- Contingent remainder In granting clause, it says: "To A for life, then remainder to B IF B survives A, otherwise to C.
  - o No comma.

Executory interests – two things help raise a red flag that you have an executory interest:

- Follows a vested remainder subject to complete defeasance
- Follows a gap of time. Ex: to A for life, then after 5 years to B.

#### Rule Against Perpetuities:

The rule, as it's stated is: No interest in property is good unless it must vest, if at all, not later than 21 years, plus period of gestation, after some life or lives in being at the time of creation of the interest.

Why have the Rule Against Perpetuities?

- Some states have done away with it.
- The purpose of the rule is because people would try and get away with holding property for perpetuity.

Are present interests subject to the Rule Against Perpetuities?

• No, because of the very wording in the rule. A present interest has already vested, so the Rule Against Perpetuities doesn't apply.

Does the Rule Against Perpetuities apply to future interests held by the grantor?

No, because it reverts back and the Grantor's life is limited.

Does the Rule Against Perpetuities apply to future interests held by grantees?

Yes.

If it's an indefeasibly vested remainder, is it subject to Rule Against Perpetuities? Yes. Vested remainders subject to open are also subject to Rule Against Perpetuities.

What interests are subject to this rule?

- not present interest (doesn't apply)
- future interest- could be
- future interest held by the grantor- (NO)
- future interest held by beneficiaries- (yes)
- indefeasible remainder- (yes)
- vested remainder subject to open (yes)

What is the measuring life (life in being)?

- Look first for a life in being. A life in being has a name.
- It must be alive and conceived at the time of the interest

# Two-prong test for a life in being: (p. 754/829)

- Must have a name
- Must be alive and conceived

Vesting – when the interest becomes possessory

So, "to my oldest grandchild upon the death of my last surviving child" – who is the life in being? You don't have to know exactly who it is, as long as there's a group that fits. It's ok if you only have one child at the child. Here the child (not the grandkid) is the beneficiary

Remember: you need to have a savings clause in all documents that create future interests.

Remember the <u>Fertile Octogenarian Rule</u>. You're never too old to have children, and you can adopt as long as you're competent

Ways that courts can handle/deal with it:

- Blue line creation of interest they cross it out, and do away with the section
- Let it go on for a while
- Doctrine of infectious invalidity courts say that if this clause violates RAP, other clauses are "infected" and all gifts that are infected fail, too.

Problem on p. 829

Prop to be distributed to grandchildren. T's will.

T to Trustee for benefit of children income for their lives, at the death of last child, then youngest grandchild.

Interest upon T's death is a present interest. Will matures at death of T.

April 7, 2005

Codes for this week:

19-3A-102 to 104 19-3A-201 to 202 19-3A-301 to 303 19-3A-601 to 605

How does RAP affect an insurance trust? When does it start affecting an insurance trust?

• When a policy matures (at the death of the insured life)

When is an insurance trust created? The trust is created when you buy a policy.

What kind of life insurance trusts are there?

- <u>Funded</u> the premium is paid (usually one payment)
- Unfunded premium is not paid, continuing to make premium payments

The <u>res</u> (aka corpus) is the contract.

Time starts ticking at the death of the insured. That is, an irrevocable life insurance trust doesn't start until death.

The purpose of an Irrevocable Life Insurance Trust is to keep it out of your estate.

# **Principal and Income Act**

# The Alabama Principal and Income Act became effective on Jan 1, 2001.

- Before the rule went into effect, there were lots of trusts established.
- What happened with trusts established before the Alabama Principal and Income Act?
  - The rule gave trusts that were established before 2001 up until 1-1-2003 to opt in or out of the plan. All you had to do was write a letter to the trustee.

Which trusts must use Alabama Principal and Income Act provisions?

- The Alabama Principal and Income Act rules are only <u>default rules</u> if you don't have a plan (trust is silent), the state uses this one for you. If you create a trust and it's silent as to how you want the principal and income is divvied out, the Alabama Principal and Income Act is followed.
- As long as you put in provisions, it will be done that way (if it's legal).
- Most trusts give the trustee discretion to determine what is principal and income.

# The Alabama Principal and Income Act answer answers 4 questions:

- How is income earned during probate of an estate distributed among trusts, beneficiaries (residual, specific, or general)?
- When does an income interest (aka property interest) in a trust begin for income beneficiaries?

- o And, what is principal and income that comes into a trust?
- When does an income interest end?
- If you have accrued income that hasn't been paid, who does it go to?
  - How should receipts and disbursements of income be allocated between beginning of income interest and end of income interest?

Because of the stock market in the last few years, there are questions about what to do when you set up a trust and it states an amount of income to be distributed, but the trust has a loss.

In situations where a trust has a loss of income, there are two theories used:

- Modern Portfolio Theory
- Total return (unitrust) Theory

These are tools to minimize the fluctuation of income in a trust.

There are two ways to get rid of income derived from specific or general/pecuniary bequests:

- Specific bequests right away
- General or pecuniary paid subject to claims against the estate

If something is generating income, who gets it? The beneficiaries.

If there is no income due to too many deaths, the beneficiaries don't get it, though.

General bequest is sitting out there, and you don't know that you have it until the end of the claims period, because it is subject to the claims.

What about residual bequests?
What kind of formula is used to create a residual bequest?

"That amount that will pass free of estate taxes..." is a pecuniary formula.

A percentage or fraction is used to create a residual bequest. If it's not a percentage or fraction, it's not residual. All income earned off of residual amounts is therefore fractional.

That means, for example, if you have 3 beneficiaries, you pay the specific, then the general, and then what's left you divide into thirds.

When you create a specific devise, you have specific income that goes with it.

- If it's a **general bequest**, it's general, and you don't know if you have it until the claims period.
- The residual is the easiest, because it's fractional of whatever is left.

#### Examples:

I give my car to sally – specific I give my trustee \$100 to care for my dog – general The rest to my church – residual

Income derived from specific bequests- right away Income derived from General or pecuniary bequests- 6 months paid

Income derived from residual bequest (percentages; can't be anything except percentages; therefore all income is fractional)

### The Prudent Investor Rule

- The trustee has a duty to invest prudently or to take care of the money prudently.
  - A prudent investment is not speculative.
  - Absent language that allows you to buy ownership in a company, you can't, because it is speculative.
- In Alabama, you could buy government bonds (or anything guaranteed by the US or state government).

The way you get around the Prudent Investor Rule is you give the trustee the power to invest in anything that they see fit.

 This is a good thing to do. If this language isn't in the document, you must follow the Prudent Investment Rule.

The list of **enumerated powers** in our state code also allows trustees to do other things. It's in the code. Includes such things as resale, etc.

## More on the Alabama Principal & Income Act

Specific – if it does have interest – beneficiaries get it.

**General** – begins when the claims period ends

Residuary – starts immediately, but you don't know what it is until everything else is paid

## Allocation of receipts during administration of estate:

You start a trust and everything in it is principal (corpus), whether it's a trust or an estate.

- That is, everything going in at first is principal.
- Subsequent to creation, it's income. Exceptions to that rule:
  - Where the fiduciary receives something other than money and the trustee has discretion as to what it is.
  - Where it's money in payments in exchange for part or all of the trust interest in a business.
  - If it is money considered a capital gain dividend for income tax purposes.
     A capital gain is where you own stock and it increases in value and you sell it, or where you get a stock capital gain dividend.
  - o If it's a principal allocation subsequent to creation.

## See §19-3A-401 through 405:

However, a fiduciary shall allocate to principal to the extent not allocated to income....

- If it doesn't go to income, it goes to principal.
- If it's in exchange for an asset you converted, that's still principal.

Liquidating asset – as you hold it, it diminishes in value.

- A copyright or 30-year leasehold agreement is a good example.
- How to account for liquidating asset income?
  - o 90% to principal, 10% to income, unless stated otherwise in the document.

How to account for receipts from mineral water and other non-renewable natural resources?

 Allocate 90% to principal and 10% to income, absent language in the document otherwise.

How to account for timber?

- Ex: you have timber property you pay \$50K for originally. You cut some trees and get back \$25K. Where does it go? Principal. Your cost basis is now \$25K.
- When the trees grow back, you cut again and get \$30K. Where does it go?
   \$25K to principal and 80% to income and 20% to principal of the remainder.
- Going forward, use the 80/20 rule.
- Remember that this is absent language in the document otherwise.
- See 19-3A-412

### **Allocation of Expenses**

First, think about the type of expense it is. Is it recurring or a one-time hit?

- If it's a recurring expense, it should be allocated out of income (if there's income funds available to cover it).
- If the expense is a one-time bill, it should usually come out of principal.
  - This is because it's usually a recapitalization or investment.
  - o Example: the air conditioner breaks and it needs to be fixed. See §501

Compensation of trustee comes out of income. Also, any recurring expenses, such as: premiums on insurance, bank fees, mineral expenses not allocated to principal, etc.

What expenses come out of principal? Usually, non-recurring expenses.

 Under the Alabama Principal and Income Act, trustees can allocate up to 50% to principal/50% to income. But grantors can specify otherwise in the document.

# Things that normally come out of principal:

- Fiduciary's fee based on transmission of an asset. Ex: brokerage fee to sell a house.
- Payment of principal of trust debt. Ex: trust owes debt
- Legal expenses concerning the trust principal. Ex: lawsuit determining whether a
  piece of property is owned by a trust
- A single premium life insurance policy (because it's a one-time payment).
- State inheritance or transfer taxes.
- Any amount that a creditor reduces a loan paid for out of principal.

Fiduciary may transfer from income to principal a reasonable amount ....

- Ex: you're paying taxes on commercial property and you're depreciating the property. Which side gets the tax benefit of the depreciation? Income.
- But you should put a reasonable amount back into principal because of the deduction.

# However, a fiduciary may not transfer form income to principal under the following circumstances:

- Portion of the real estate that's earning the money is used by the beneficiary personally
- ....Estate should be a temporary vehicle. You never recapitalize income in an estate. It always stays separate.

If for some reason, income is accounted for differently because it's a business, you can take it from income to principal.

Remember, the Alabama Principal and Income Act is used only when the document is silent on something.

- The act came into effect 01-01-01. People had until 01-01-03 to decide if they
  want to go to it. Trusts made between 01-01-01 and 01-01-03 had to make a
  decision or they had to use it.
- Trusts after 01-01-03 that are silent on something covered by the Act have to use the Act.

### Powers of Trustees:

- Corporate trustees have the power to commingle assets of trusts that are similar or alike. Corporate trustees can do this if they keep the accounting on the separate trusts.
- Power to invest assets of the trust (the prudent investor rule AL Code §19-3-320)
  - Henley case trustee must make careful, prudent investments, exercising his own special skills to both preserve the corpus and to produce a regular income from the trust assets.
  - o Trustees don't have to **grow** the assets, but they do have to **preserve** the corpus and earn some income.
  - Trustees can't invest in marketable securities or traded equities because they are strictly speculations. Investing in something that can lose money is not a "prudent investment" under the definition.
    - Get around this by putting in enumerated powers that allow such investing.
  - Trustees can invest in US bonds or other interests backed by a government, school board, county, etc. (see AL Code §19-3-120)
- Power to terminate small trusts.
  - Eventually a trust may become too small that administering it becomes too onerous.
  - o In Alabama that is \$25,000. If a trust falls to or below \$25,000, you can terminate it.
  - Or, where the cost of administering the estate is more than it's worth to keep it.

The **Enumerated Powers** are at AL Code §19-3-322. These powers can be put into documents (about 27-28 of them). They say that trustees can invest in stocks.

### **Administration of Trustees:**

- Trustees take only the amount of title they need to do what they need to do.
- A unanimous decision of co-trustees is needed to make decisions, absent language in the document otherwise.
- You do not need unanimous decisions of all co-trustees in exigent circumstances.
- You do not need unanimous decisions of all co-trustees where the power to act of all trustees have been delegated to a single trustee. (see AL Code§19-3-325)

### Court removal of a Trustee

- Upon the filing of a complaint by any person interested in the execution of the trust (can be a beneficiary or another trustee), the circuit court may remove any trustee who has harmed (or if not removed will harm) the trust.
- What does it take to have them removed? You must show cause. Generally hard to do unless the actions are egregious.
- Business decisions are not usually enough it's hard to prove that something was a bad decision. But stealing is enough.

- What are you on the hook for if you're removed as trustee?
  - o Removal from trustee position
  - Any loss of principal
  - Any loss of income

#### **REVIEW**

- Why was the estate tax created/initiated?
  - The federal estate tax was introduced in 1916 and targets the wealthy.
     They wanted to prevent the ultra-rich, super-elite from running the country
- Who were the two guys who were primarily involved?
  - President Teddy Roosevelt and Andrew Carnegie
- What are the different types of trusts (testamentary, marital, family, inter vivos, etc.)? Know all the labels you can put on trusts.
  - o Trust labels:
    - Testamentary created in a will
    - Inter vivos (aka Living Trusts) created during the settlor's life
    - Express trust grantor communicated his intent to create a trust in very clear terms
    - Implied trust there is an implication of a trust
    - Constructive trust not really a trust at all, but an equitable remedy constructed by courts to prevent unjust enrichment
    - Resulting Trust settlor attempted to make a trust but didn't do something properly, so courts create a "resulting trust"
    - Simple Trust all income goes out, it's never accumulated; no charity is involved.
    - Complex Trust different beneficiaries for principal/income or present/remaindermen; or any beneficiary is a charity
    - Dynastic Trust a trust set up to benefit some of your descendants for as long as you can with as little tax as possible; takes advantage of the GST exemption
    - Accumulation trust a trust for the sole purpose of accruing wealth and growing money. The longest it can go is for 10 years.
  - Types of trusts:
    - Family Trust generally funded with the applicable exclusion amount
    - Marital Trust surviving spouse gets money
    - QPRT (qualified personal residence trust) deals with real estate use a QPRT table ex: I want to give my \$2m house to my kids without putting it in my estate. Tables tell how long it has to be in the QPRT to make it tax-free. The whole time its in the trust, it's yours, but if you die before it matures, it's in your estate. But if you live as long as the tax tables tell you, it won't be in your estate. It must be your primary or vacation home (no rental property). They get it automatically at the end of the tax table time, and at that time you must pay rent if you want to stay living there because it's theirs. Once you set it up, it's irrevocable. You can swap houses, it applies to whatever house you're living in. If you outlive the period, it's not in your estate. No step-up in value.

- Spendthrift trust no money given to beneficiaries' trust; protects the beneficiaries from themselves
- Charitable trusts set up to help a charity
- Charitable Lead trusts benefits a charity up front and you get paid at the end.
- Charitable Remainder trusts benefits the charity after you've been paid
- Grantor-retained income trusts
- What is the most fundamental duty the administrator owes the trustee?
  - Duty of Loyalty
- Understand about the creation of trusts who is involved?
  - o Grantor, beneficiary, and trustee
- What does it take to create a trust (what are the elements)?
  - o Grantor (with intent, capacity, and a defeasible interest in property)
  - o Property (aka corpus)
  - o Beneficiary
  - o Trustee
- What is most and least fatal to the creation of a trust.
  - The property (corpus) is the most important without it there is no trust.
  - The least important is a trustee a trust won't fail for lack of a trustee, the court will assign one.
- Know about the bundle of rights theory.
  - You must have possession, management, enjoyment, and disposition of the property to be able to truly say you owned the property.
- What is important about the grantor/settlor's intent?
  - o Intent must be definite and ascertainable, not precatory.
- Once you've created the trust, what are the formalities?
  - Grantor must have capacity
  - If the trust contains real estate or property worth over \$500, it must be in writing. Otherwise, an express oral trust may be found valid.
- What happens if some of the formalities fail?
  - Two types of trusts may be created by the courts: constructive and resulting.
    - Constructive Trusts not really a trust at all, it's an equitable remedy constructed by the court. Used to prevent unjust enrichment.
    - Resulting Trusts settlor had great intent but didn't do everything perfectly, but courts enforce it anyway.
- Totten trusts and Alabama's treatment thereof.
  - o In other states, Totten trusts are treated as "payable on death accounts."
  - Alabama doesn't like Totten trusts. Alabama statutorily recognizes them, however. Alabama courts prefer not to favor them.
  - They present a problem because the presumed state of Totten trusts (without language otherwise) is irrevocable. In Alabama, they are elevated to the position of a regular/real trust. They have status as traditional trusts.
- Duties of trustees (a laundry list)
  - o Loyalty
  - o Trustee may not delegate his duties
  - Keep and render accounts

- o Furnish information to beneficiaries upon reasonable request
- o Duty to exercise reasonable care
- Take and control the property assets
- Preserve trust property (by insuring it, preventing theft or damage, and maintaining the property)
- o Make the trust productive
- o Enforce claims
- Defend actions
- Keep trust property separate
- o Pay income to beneficiary if required
- o Deal with beneficiaries impartially
- Work with co-trustees
- Administration of trustees
  - o What are things that might get a trustee in trouble?
    - Trustees take only the amount of title they need to do what they need to do.
    - A unanimous decision of co-trustees is needed to make decisions, absent language in the document otherwise.
    - You do not need unanimous decisions of all co-trustees in exigent circumstances.
    - You do not need unanimous decisions of all co-trustees where the power to act of all trustees have been delegated to a single trustee.
  - What are the trustees on the hook/liable for if they mess up?
    - Removal from trustee position
    - Any loss of principal
    - Any loss of income
- May a trustee delegate his authority?
  - No. A trustee may not delegate his authority.
- Trustee powers
  - o Power to commingle assets
  - o Power to invest assets
  - Power to terminate small trusts
- Prudent investor rule
  - The trustee has a duty to invest prudently or to take care of the money prudently. A prudent investment is not speculative. Absent language that allows you to buy ownership in a company, you can't, because it is speculative.
- Understand about avoiding probate is there any real reason to avoid it? If so, what is it?
  - The only reason to do so is for privacy. That's the only legitimate reason

     it may be a little quicker, and will save you hardly any money at all. But
     a trust is a private document.
  - If that's a practice (avoiding probate), what tools can you use to do it?
     Trusts
- Irrevocable trusts know what they are and how they work
- Life insurance trusts (irrevocable)
  - Two types of irrevocable LI trusts know what they are and the difference
    - Funded the entire premium is paid for up front
    - Unfunded use annual excludable gifts to pay every year

- Understand the benefits of a life insurance trust
  - Life insurance trusts create liquidity
  - It could help cover the expenses of estate taxes because of the liquidity
  - It could help protect a small business
- Understand how the Rule Against Perpetuities affects Life Insurance trusts
  - The statute doesn't start to toll on a life insurance trust until the policy matures. That is, the rule doesn't apply to the trust until the policy matures. The policy matures when the insured life dies.
- Difference between support and discretionary trusts
  - What are benefits of discretionary trusts
    - A Support Trust says you need to pay ("shall pay") some person some amount to live on. They are generally mandatory payouts.
    - Discretionary Trust is left to the discretion of the trustee as to how much to pay. It can be either absolute discretion or ascertainable standards.
  - How do you invoke/create a discretionary trust
    - Use language such as: the trustee may in his discretion pay out funds to the beneficiary for the following..."
  - o What's a sprinkle trust?
    - Also known as an absolute sole discretion or "common pot" trust. Several beneficiaries all take from the same pot, and the trustee has discretion to determine which beneficiary gets what amount. That is, they can "sprinkle" the assets, and the assets don't necessarily fall equally.
- Know what ascertainable standards are.
  - Ascertainable standards stated by the IRS are support, maintenance, health, or education.
- If you have a family trust with ascertainable standards, is it still a family trust?
  - o Yes, it's still good as long as there are ascertainable standards
- When a trust is discretionary and the grantor is not the beneficiary, can creditors
  of the beneficiary get at the trust assets?
  - o No, because the beneficiary doesn't own the trust assets since the trustee has the discretion whether or not to pay out trust money.
- Understand if it's a support/discretionary trust, is there a duty for the trustee to find out what the needs of the beneficiaries are?
  - Absent language in the trust document, a trustee has no duty to go find out what the beneficiaries need.
- Understand spendthrift trusts why use them? What do they do?
  - o Spendthrift trusts protect to beneficiaries from themselves.
  - The grantor may give a beneficiary the power to invade or for the trustee to give them what they need, but they can't anticipate their interest in the trust, alienate their interest in the trust, or mortgage their interest in the trust.
  - Spendthrift is someone who wastes their money away and are likely to spend the money away. A spendthrift clause protects them from wasting their interest in the trust. "No beneficiary can anticipate, etc" is the spendthrift clause. So now they can't sell their interest in the trust.

- Other good thing about a spendthrift trust is that you get it away from divorce proceedings because they can't anticipate or mortgage it.
- Which trusts give more protection from creditors, alimony and child support.
  - Spendthrift trusts the trust isn't liable for the debts of the beneficiary
  - But child support is a gray area sometimes courts are more lenient on attaching child support than a creditor's loan.
- If a creditor was going to attach that may not be attachable, what's the best way for them to get their money?
  - o They'd need to attach to the beneficiary's individual assets.
- Taxation of trusts
  - Understand which tax bracket a trust pays taxes in (name it)
    - For income tax purposes, trusts are taxes at the highest personal tax rate bracket possible (27.8%).
    - In estate taxes, you get a "run up" in brackets, meaning you pay as much as you can at each of the lower levels. This is how it works in income tax, because that's the way the tax tables are fixed.
    - Trusts must file a Form 1041 when they have income.
- Understand the difference between a grantor trust and a non-grantor trust and the taxation thereof. Who is hooked with the liability?
  - A revocable life insurance trust doesn't give the grantor any estate or income tax benefits. All income from a grantor trust is taxed back to the grantor at the grantor's level.
  - o If it is a complete irrevocable trust (aka non-grantor trust) and the income is supposed to be going to someone other than the grantor (and it can never go back to the grantor), the entire tax goes back to the trust or to the beneficiary (if received). That is, if the grantor has no control over the trust, the trust or the beneficiaries may pay the tax.
- Understand the concept of Crummy trusts and how they work. How do you get around the present/future interest problem with Crummy trusts?
  - In order for a gift to be "complete," it must be a present interest. With a
    Crummy trust, you turn what would be a future interest into a present
    interest by giving the beneficiaries a right to get their money out each
    year for a small period of time.
  - o Crummy trusts are considered a gift of a present interest because they have a window to go get the money out.
- How do you make sure a trust qualifies for the marital deduction?
  - o The spouse must (not *may*) have get the entire net income at least annually during his/her lifetime; and
  - The surviving spouse must have the power to appoint the principal OR they have to have the ability to invade the principal OR check the QTIP box.
- Question: Trust says income to spouse annual, and at her death to Joe. What kind of trust?
  - Terminable Interest Property Trust
  - But if you check the box for Qualified Trust (electing QTIP) on the estate tax return, it's a QTIP trust, and is therefore included in the spouse's estate as long as she took the annual net income and you've chosen who it goes to at her death.

- If you don't check the QTIP box, it goes back to the testator's estate instead of the spouse's estate.
- Understand what a QTIP trust is.
  - QTIP = Qualified Terminable Interest Property
    - Note: this is a different thing that a QPRT trust
  - o Who benefits in the income? Who benefits in the remainder?
    - Surviving spouse gets the entire net income at least annually during their lifetime.
      - It's counted in the surviving spouse's estate for estate tax purposes.
    - Person of testator's choice benefits in the remainder.
  - o How to create one?
    - Check the box! Do it, and you get to keep up your spouse while she's alive, but you still get to pick who gets the money.
  - Why did they create the QTIP?
    - Because all the congressmen had second and third wives with kids and they wanted their own kids to get the money rather than their new wife's kids.
  - o Can the wife invade without it being included in testator's estate?
    - If there are ascertainable standards.
- What's a dynastic trust and how do you create one?
  - o A trust that takes advantage of the GST exemption (see above).
- Know about Modification and termination of trusts.
  - o If a trust is irrevocable, the grantor cannot modify it.
  - Understand about how all parties agree together and what must be present if all parties agree.
    - If everyone is in agreement, trusts can be changed but all parties must consent – no matter whether it's revocable or irrevocable.
  - o Know the term sui juris
    - What happens if a beneficiary is a minor? They aren't legally competent to make decisions regarding changing a trust.
    - Sui juris means competent. So a minor is not sui juris.
- When to modify trusts when beneficiaries do not consent?
  - o If there are adverse conditions where the needs and conditions of a beneficiary trust have arisen, a trust can be modified by the courts. If it's a private trust (not charitable), it's changed through the doctrine of equitable approximation. Courts are hesitant to change dispositive provisions (who gets what), but may change administrative provisions.
- What might be considered termination by operation of law?
  - If a trust is set up for a future occurrence of a particular event for example an escrow account for a home purchase – when the event happens, the trust is over.
- Know about Merger of interests/Merger of Title.
  - Alabama law says if you merge the equitable and legal title and the same person holds both titles, the trust if terminated.
- Charitable trusts
  - O What does it take to create a charitable trust?
    - The person in it must be charitably-inclined. Look to federal tax status to determine if an organization has a charitable purpose.

- Who decides what a charity is?
  - Federal tax status helps.
- What's the designation you give to those organizations?
  - Tax-exempt status 501(3)(c) status
- In Alabama, who decides (other than the fed government) what a charity is?
  - Alabama if Alabama recognizes a company as a charity, the federal government will.
- What is the trouble that arises by creating a charitable trust for an unincorporated entity?
  - It's a problem because an unincorporated entity can't hold title to property.
- Complex and simple trusts know the difference
  - Complex trusts different beneficiaries for principal/income or present/remaindermen; or any beneficiary is a charity
  - Simple trusts all income goes out, it's never accumulated; no charity is involved.
- Understand how charitable trusts are created as far as the Rule Against Perpetuities.
  - o The Rule Against Perpetuities doesn't affect charitable trusts.
- What elements are required to create a charitable trust?
  - You must go through all the same formalities as when creating any other trusts – intent, corpus, trustee, beneficiary.
- Who enforces charitable trusts?
  - o In Alabama, the Attorney general enforces charitable trusts.
- Once created, how do you modify a charitable trust?
  - The Cy Pres doctrine is used to change a charitable trust it can only modify/change a charitable trust.
  - o Who can do it?
    - The courts
  - What is the 3-prong test used to determine if judges want to use cy pres?
    - It must be a charitable trust (they must be able to identify the charitable intent).
    - It must not be impossible, impracticable, or illegal for the trust to achieve its purpose.
    - There must be general charitable intent.
  - When can cy pres not be used?
    - If any of these are present the court would probably not use the cy pres doctrine:
      - they stated a specific use for the money (the donor had specific charitable intent)
      - the donor set up "catchalls" (he anticipated failure of the gift)
      - the donor created contingent disposition of the money
  - What do Alabama jurists think about the cy pres doctrine?
    - Alabama courts do not like to use cy pres it is disfavored because they feel like they're changing the intent of the donor. However, it has been adopted and used. The courts think the doctrine is too heavy-handed.
- What do Miller trusts (aka special needs trust)?

- They allow someone to qualify for medical benefits from a government entity.
- Power of appointment
  - How is it created?
    - It must be in writing and must have specific references back to the document creating the power, so as there's no question as to which power you're exercising and which document you're referencing.
  - o Know what it is and how it works.
  - o How is it exercised?
  - Know the scopes of the power of appointment.
    - Power of Appointments can be either:
      - General the person holding the power of appointment can do anything and everything. Holding such a power immediately moves the assets to be appointed to the donee's estate.
      - Limited often used in family trusts; the person holding the power has a limited amount of power.
  - Tax consequences of power of appointment.
    - It's in your estate if you have it even if you don't use it.
  - What type places the asset in the donee's estate? What type does not?
    - General puts the asset in the donee's estate
    - Limited does not put the assets in the donee's estate, but stays
      in the donor's estate (the person who's giving the power)
- Rule Against Perpetuities
  - Understand future interests in that you are able to determine what is vested, what is not, and what is subject to open.
  - Know what a measuring life is.
    - A life in being must have a name and must be alive and conceived.
  - o Know what a remainder is.
- Know which future interests are held by the grantor, which are held by the beneficiary. (don't worry about the comma thing)
  - Grantor-owned Future Interests
    - Possibility of reverter automatically reverts.
    - Right of entry/re-entry generally says may come in.
    - Reversion it lasts a specific period of time, or upon a specific event it comes back to the grantor.
  - Future Interests held by donees/beneficiaries:
  - Vested you know who has the interest. Three types:
    - Indefeasibly vested remainder
      - Outright to B
    - Vested remainders subject to open (aka partial defeasance)
      - Ex: to A for life then A's children the more children A has, the less they get.
    - Vested remainder subject to complete defeasance
      - Very technical
      - The only difference between it and the contingent remainder is where you put the comma.

- This one uses: "To A for life remainder to B, if B survives A, otherwise to C." it's vested.
- Contingent you don't know who has the interest until it vests
  - Ex: To A for life, then her children.
- AL Principal and Income Act
  - Know when it was enacted and when it was effective
    - The Alabama Principal and Income Act was enacted on 1-1-01.
    - It went into effect on 1-1-03.
  - What happens to trusts created before/after the act?
    - Trusts had until 1-10-3 to decide to opt into the plan.
    - The Alabama Principal and Income Act rules are only default rules if you don't have a plan, the state uses this one for you. If you create a trust and it's silent as to how you want the principal and income is divvied out, the Alabama Principal and Income Act is followed.
  - Don't worry about 80/20 type specifics