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Worth It Episode 7: Lifetime Planning - The Benefits of Creating Lifetime Trusts for Children and Other Descendants

July 16, 2021

In this episode of Worth It, Proskauer Associate Dan Hatten and Senior Counsel Nathaniel Birdsall discuss why clients should strongly consider planning with lifetime trusts for their children, grandchildren and more remote descendants.

Dan Hatten: Hello and welcome to Worth-It, a podcast brought to you by Proskauer's Private Client Services Group covering a wide range of topics concerning estate planning, wealth transfers and important new developments and other issues our clients frequently face in organizing their estates. My name is Dan Hatten, Associate in Proskauer's New York office. In this episode we'll be discussing why clients should strongly consider planning with lifetime trusts for their children, grandchildren and more remote descendants. Joining me for this episode is Nat Birdsall, Senior Counsel in Proskauer's New York Office. Welcome Nat.

Nathaniel Birdsall: Thanks Dan. Thanks for having me.

Dan Hatten: Thanks for joining let's start from the beginning for this question. When would a client consider creating a trust at all for his or her children?

Nathaniel Birdsall: There are two situations where a client might create such a trust. One is during lifetime when a client creates and funds a trust for child in part to move assets out of the client's name. So the client ultimately has a smaller taxable estate at death. And then the second situation is actually at death when the client provides in a Will or other estate planning document how children should inherit assets when the client dies or you know when the client and the client's spouse die.

Dan Hatten: That leads to a big question. If I, as a token of my admiration for you, wanted to make a gift and leave you a bequest, would you prefer to receive it outright or would you prefer to receive it in trust?

Nathaniel Birdsall: I've been waiting so long for somebody to ask me that question I would 100% want to receive that gift in trust, thank you. You know, as an estate planner, I love trusts and that's always our default recommendation if the dollar amounts involved or substantial. And to be clear throughout this episode we're talking about irrevocable trusts. Trusts that can't be changed. Not revocable trusts, which are kind of like will substitutes. I'll acknowledge right off the bat the outright transfers can be simpler and more straightforward and there are some extra costs involved with trusts, you know with a trust you may need to file income tax returns which results in additional accounting costs, you need the help of a lawyer to create a trust, and then from time to time thereafter to assist. For example, if you want to change the trustees down the line. And sometimes children are very wary of the trust - feeling it's an imposition or representing the lack of confidence on the part of their parents in the child's ability to handle their own finances but in the end I think these negatives are a minor compared to the many benefits.

Dan Hatten: And what are those benefits?

Nathaniel Birdsall: I think for purposes of this discussion we can put the benefits in to four broad categories that overlap somewhat. These are my personal categories, this is not in any you know trust handbook. I would say the first type of benefit is the assets and the trusts are not reachable by a child’s creditors and that’s because the child doesn’t legally own the assets, the trust does. So if a child causes a car accident or declares bankruptcy or has some other calamity in their life the assets of the trust can’t be reached by third parties. And this is particularly beneficial if the child ends up working in a field with the high risk of malpractice litigation you know like a doctor or an attorney. In most cases the assets in the trust should be protected from creditors and not subject to judgments.

Dan Hatten: What about in the event of divorce? Is the child divorcing spouse considered a creditor in that same context?

Nathaniel Birdsall: Yeah that's true, but I sort of consider this to be the second of the four benefits I mentioned. The fact is that a trust is not reachable by a divorcing spouse under most state laws. There are some potential exceptions and extreme facts can lead to extreme results. Such if the trust is the only source of income for both the child and the child's spouse for a long period of time. However usually an asset open trust would not be subject to equitable distribution or community property claims in the event of divorce.

Dan Hatten: A lot of clients ask this when you bring this up and want to know about prenuptial agreement if that's enough instead of keeping the assets in trust. Can you tell us a little about that?

Nathaniel Birdsall: If you've got a child that's willing to ask for a negotiated prenup with a potential spouse that's usually a good idea no it's a great idea but you can't guarantee that a prenup is going to happen or that the terms of the prenup are going to adequately protect inherited assets or that the child isn't going to later voluntarily co mingle assets with their spouse regardless of what the prenup says, for instance putting inherited property into joint name with their spouse. And you particularly can't guarantee any of those things when a child is still young or when a child hasn't even been born yet and you don't know who they're going to grow up to be, who they're going to marry or whether you, the donor, will be around to see any of it. So there's a lot more certainty with the trust where the person giving the assets gets to make some of these decisions rather than just hoping that their child will make good decisions down the road.

Dan Hatten: What about the third benefit of a trust that you mentioned?

Nathaniel Birdsall: The third one is tax savings. Using trusts to avoid taxes that might otherwise be imposed in the future if the assets have been given to a child out right. And I'll say off the top that there are lots of different types of trusts. GRATS, QPRTS, SLATS, life insurance trusts. I know you've discussed the tax advantages of some of these specific types of trusts in other episodes so I'm not going to go into any specifics on any particular type of trust but in general by transferring assets to an irrevocable trust the hope is that you can avoid a future estate tax. There's possibly another kind of tax called the generation skipping transfer tax or the GST tax which is imposed when assets ultimately pass to grandchildren and more remote descendants. For instance gifts made during your lifetime the goals is to remove assets from your own name so that they aren't subject to estate or GST tax to death. The earlier that you do that, the earlier that you put money in trust the better since all future appreciation on those assets grows free and clear of any estate tax. So for example, if you put a million dollars in a trust for a child and then it grows to three million by the time you die, that full 3 million is not subject to any estate tax at your death because it's an asset of the trust, it's no longer yours. At present the estate tax is considerable you can it can run up to about 50% in the aggregate if you live in a state like New York that imposes its own state level estate tax on top of the 40% of federal estate tax.

Dan Hatten: Wouldn't those same tax savings exist if you made the gift outright to the child or to the child using trusts? In both cases the asset doesn't belong to you so why is it any different?

Nathaniel Birdsall: That's true, you have the same estate tax savings if you gifted that 1 million outright to the child. Still there's no estate tax at your death since you don't own it. However, if you make that gift outright those assets may be subject to estate tax at the death of the child because they belong to the child. So at that child's death that $3 million or whatever amount it's grown to will be added to the value of his or her other assets and maybe subject to estate tax but if you gift that asset in trust you're avoiding the imposition of estate tax as long as that trust continues. So there's no estate tax at donors death, there's no estate tax at the child's death, there's not even any estate tax at the death of the grandchildren or more remote descendants who can step in as beneficiaries when the child dies.

Dan Hatten: And that's a lot about the tax savings. Are there income tax benefits to a trust as well?

Nathaniel Birdsall: Yeah particularly for a trust created during lifetime there is a huge potential benefit and for this purpose we're going to call the creator of the trust the grantor of the trust. So if that grantor is given certain technical powers over the trust, the trust is considered a grantor trust for income tax purposes. That means a lot of things but most importantly for us while the grantor is living all of the income earned by a grantor trust is treated for income tax purposes as if it was earned by the grantor. And that means the grantor pays all of the income tax for the trust. That is a huge, huge advantage. Every time the grantor makes a tax payment, instead of the trust, and that includes ordinary income, capital gains, everything it's like the grantor made a tax free gift to the trust. You're essentially allowing the trust to grow tax free as long as the grantor is living.

Dan Hatten: So that's the third benefit. What about the fourth benefit? What's that category for you?

Nathaniel Birdsall: I think the fourth benefit is just one that may be most obvious to someone hearing about trusts for the first time and that's the ability to pick trustees and set trust terms, protect a child or other beneficiary from making bad choices that would deplete the trust assets you know setting the terms of the trust the grantor can restrict or encourage certain investments you know indicate under what circumstances distribution should be made and these provisions last even after the client is gone or is no longer around to express their wishes. You know in a lot of cases we end up recommending that the client give the trustees you know absolute discretion make distributions whenever they deem it advisable and that provides a lot of flexibility or addressing changing circumstances in the future but you know of course it's a case by case question you know there are a lot of specific circumstances where different trust terms are needed for a specific reason such as if you have a child with special needs or disabilities or if a child has a drug or alcohol addiction you know whatever the circumstance the trust can be drafted in a way that provides the necessary protection and I think default example of when a trust is necessary is if you die while your children are still minors or young adults. Not many people want to leave assets to a child is too young to responsibly handle that wealth. Someone the trustee needs to handle financial matters until the child is of age and even once a child turns 18 I try not to talk in absolutes but it's generally never a good idea even though you could give a lot of money to someone who is 18 and it's rare that someone does so. Much more common is putting assets in trust appointing one or more trustees to oversee investments in distributions and providing when the child attains some specified age they begin to have a measure of administrative control over the trust.

Dan Hatten: And what is administrative control over the trust? What does that mean?

Nathaniel Birdsall: Well for example a child of specified age chosen by the grantor can be granted effective control over the assets of the trust and this is done for instance by allowing the child to act as a co-trustee or granting the child the power to remove and replace the other trustees or even granting a child the power to be the sole trustee. We often do that or suggest this as a sort of two-tiered structure where you're picking two different ages. So one age, for example, age 30 when they reach that age the child can be granted the power to act as the co-trustee with someone else. The child can't make unilateral decisions and the other trustee still effectively controls all distribution decisions and we think of this as the apprenticeship stage of the trust where the child is involved in trust decisions, seeing the assets, seeing how things work but can't really have complete control. And then at some second age, for example 35, the child can be granted the power to fire the other trustees and appoint trustees of their own choosing. For instance, their best friend or maybe at that age they get the power to act as the sole trustee.

Dan Hatten: Does it cause any problem if the child acts as his or her own sole trustee or otherwise have these administrative controls?

Nathaniel Birdsall: In terms of tax problems, beneficiaries as sole trustees shouldn't be granted the absolute discretion to make distributions to themselves for any reason whatsoever. That's problematic and that sort of level of power should only be exercised by co-trustee. However a beneficiary acting as sole trustee can safely be given the power to make distributions to themselves for certain specified purposes. Classic example being distributions limited for purposes of providing for the beneficiary's health, education, maintenance and support so that works.

Dan Hatten: What about a child's residence. Is a trust a good option to own a child's home long-term?

Nathaniel Birdsall: As an estate planner my bias is to keep assets in trusts as long as possible. Clients often see that a child wants to buy a house and then they ask the trustees to make an outright distribution of cash so the child can buy the house and that's fine but where possible I much prefer to arrange things so that the trust itself buys and is the owner of the residence. The child and his or her family can still reside in the house and you can even provide that the child is responsible for paying you know most of the day-to-day expenses of the house but it's the trust that's the legal owner and it's the trust's name on the deed and that way the house isn't subject to estate tax, if the death of the child isn't reachable by creditors, isn't reachable by divorce all of the benefits we previously discussed and if the house is eventually sold the sale proceeds stay in the house they don't go to the beneficiary.

Dan Hatten: Thanks for explaining those options I think it's helpful for clients to understand the trust can be as rigid or as flexible as they might want depending on the circumstances. You know we talked a lot about that. Is there anything else clients should consider when deciding whether to use lifetime trusts for their children, their grandchildren, great grandchildren so on?

Nathaniel Birdsall: Well I think it's important to be realistic about the ongoing costs of administering a trust. There are some extra legal and accounting fees and also depending on who's appointed as trustee the trustee may want compensation for you know serving in that rule and because of these additional costs the trust might not make sense for you know a smaller disposition but these costs are likely worthwhile for a lot of clients who are thinking about transferring you know generational wealth rather than you know tens of thousands or maybe even hundreds of thousands of dollars and I think you know this as well for a lot of people the hardest part of this process is picking trustees and really identifying someone in whom you have that level of trust to give them so much responsibility and control over your child's future. Everything you know becomes easy if a client has one or two people in their life that they are comfortable appointing in that role if there isn't anybody things are a little bit harder and then you better think about appointing a trust company or professional trustee which has added costs and maybe the terms of the trust would look a little bit different. You know these are all problems that can be worked through with an Estate Planner and getting you all the options. No doubt about it there are some more steps doing a trust.

Dan Hatten: Got it. Thanks Nat for coming on Worth It and discussing planning with lifetime trusts. As you discussed we generally recommended that clients consider planning with lifetime trusts especially when transferring significant assets to their children, their grandchildren, more remote descendants. It seems because of the tax benefits the creditor protections the spousal protections and administrative flexibility that allows clients to learn to have as much control of the assets as the client wants while still protecting those assets on various fronts including in particular from divorcing spouses. So thanks again for helping us through this.

Nathaniel Birdsall: Thank you Dan.

Dan Hatten: With that we'll wrap up this episode of "Worth It." We hope you enjoyed this podcast. To join us for future episodes, be sure to subscribe to Worth It from Proskauer on Apple Podcasts, Spotify or Google Podcasts. Thank you for listening.

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