Basic Estate Planning Documents:

Revocable Trusts

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Jessica L. Lambert
Choate, Hall & Stewart LLP
jlambert@choate.com
(617) 248-5223

Courtney N. Carr
Choate, Hall & Stewart LLP
ccarr@choate.com
(617) 248-5225
Overview

• **What** is a revocable trust?
• **Why** are revocable trusts used in estate planning?
• How to **create** a revocable trust
• Key provisions during the Grantor’s **lifetime**
• Key provisions after the Grantor’s **death**
  - Trust structure on the death of the first spouse (marital deduction planning)
  - Trust structure after the death of both spouses
• **Termination**
Basic trust terminology

Cast of Characters:

- **Grantor**: Person who creates the trust. (aka – Settlor, Trustor, Donor)

- **Trustee**: Person who receives the property and agrees to hold it for the benefit of the beneficiary.

- **Beneficiary**: Person for whose benefit the trust property is being held.
Basic trust terminology (continued)

All trusts are either:

- “Inter vivos” or “Testamentary”
  - Inter vivos = Established during the Grantor’s life. (sometimes called a “living” trust)
  - Testamentary = Established at death through a person’s will.

- Revocable or Irrevocable:
  - Revocable = Grantor retains the right to terminate the trust and reclaim the assets.
  - Irrevocable = Grantor does not retain the right to terminate the trust and reclaim the assets.

Current Default Rule: Trusts governed by Massachusetts law are revocable and amendable unless the trust instrument expressly provides otherwise. MUTC § 602(a).

NOTE, however, that the current default rule applies only to trusts created after the effective date of the MUTC (July 8, 2012). Pre-MUTC trusts are irrevocable by default.
What is a revocable trust?

It is a trust that:

- Is created during the grantor’s lifetime, and
- Can be revoked by the grantor without the consent of the trustee or a person with an adverse interest.

[MUTC § 103.]
What is a revocable trust? (continued)

- **Funding**: Can be funded during the Grantor’s lifetime or at death
  - During life: By opening an account in the name of the trust and transferring assets to that account, or by retitling assets in the name of the trust.
  - At death: By direction in the Grantor’s will or by beneficiary designation.

  "I give all the residue of my estate to the Jane Doe Revocable Trust."

"Pour over Will"
What is a revocable trust? (continued)

- **Tax Attributes:** No tax advantages during the Grantor’s lifetime.
  - Income earned by assets in a revocable trust are taxed to the Grantor b/c the trust is disregarded for income tax purposes under the grantor trust rules. IRC § 676.
  - Transfers to a revocable trust during the Grantor’s lifetime are incomplete gifts. IRC § 2511.
  - Upon the Grantor’s death, all of the assets in the trust will be included in the grantor’s taxable estate at death. IRC § 2038.
  - Trust does not need a separate EIN during the grantor’s life (but will need one at death).
Why use a revocable trust?

• A revocable trust offers greater **privacy** and **flexibility** than disposing of property directly in the will.
  
  o Unlike a will (which is a public record), a revocable trust is a private instrument and is not filed with the probate court.
  
  o Unlike a testamentary trust, assets in a revocable trust do not require ongoing supervision by the probate court (e.g., no trustee bond or probate accountings; much easier to appoint and remove trustees).
  
  o Assets contributed to a revocable trust during the Grantor’s lifetime are not subject to probate, and are immediately available to the trust beneficiaries.

• Planning for Incapacity: If funded during the Grantor’s lifetime, trustees can make distributions of trust property to the Grantor and his/her family.

• **NOTE:**
  
  o No creditor protection for Grantor during lifetime or at death, but creditor protection for beneficiaries after Grantor’s death.
  
  o No tax benefit or detriment to lifetime funding. After Grantor’s death, trust can be structured to minimize transfer taxes.
How to **Create** a Revocable Trust?

- **Nominal funding:**
  - “I, [________], as Grantor, have transferred ten dollars to [_______], as Trustees. By their signatures to this instrument, the Trustees agree for themselves and their successor Trustees that they will hold the transferred property, and anything added to it from any source, in trust on the following terms.”

- **Power to revoke and amend:**
  - “For as long as I am living and competent, I may from time to time amend all or any part of this instrument, or revoke it entirely, by delivering to the Trustees an instrument to that effect signed by me.”
  - Consider granting the trustees the power to make administrative amendments after the grantor’s incapacity or death

- In Massachusetts, revocable trusts do **not** require the same execution requirements as wills (e.g., witnesses)
During the Grantor’s Life

• **Trustees:**
  – Grantor can serve as sole trustee
  – Grantor has power to hire and fire trustees.

• **Assets/Funding:**
  – Need not be funded during Grantor’s lifetime.
  – If not funded during life, will exist only on paper – will be funded at death.
  – Funding occurs by retitling bank accounts, real estate, etc. in name of the trust

• **Distributions (if funded):**
  – Grantor has complete control to direct distributions.
  – Completed gift if distribution made to someone other than Grantor.
  – If Grantor becomes incapacitated, trustees can have power to make distributions to or for the benefit of Grantor and others named in trust (e.g., Grantor’s family, charity)
Upon the Grantor’s Death

• Trust becomes irrevocable.

• **Debts, taxes, and expenses** are paid.
  - Trustees and personal representatives will pay the costs of administering the decedent’s estate, and any taxes that may be due at death.
  - Personal representative will need to determine who will bear the economic burden of taxes and expenses (for example, recipients of assets passing under the will or revocable trust, or recipients of non-probate property). This is known as “tax apportionment.”
  - Apportionment is a complicated subject, and will frequently require careful thought and drafting based on the client’s specific circumstances.
Upon the Grantor’s Death (continued)

Funding:

• Upon the Grantor’s death, the revocable trust will hold the following property:
  o Any assets transferred to the trust during the Grantor’s life
  o Residue of the probate estate by operation of pour-over will. MUPC § 2-511.
  o Non-probate assets, if trust specifically designated (e.g., retirement accounts)
  o Property subject to powers of appointment, if exercised in favor of the trust

• But will NOT hold the following property, which passes outside of the trust:
  o Jointly held assets (such as bank accounts and real estate)
  o Property with specific designated beneficiaries (e.g., life insurance, retirement assets, transfer-on-death (“TOD”) accounts)
  o Bequests under the will, which are made before the trust is funded.
  o Assets gifted during life, outright and through irrevocable trusts
Upon the Grantor’s Death (continued)

- After the Grantor’s death, the trust instrument will direct how the trust property will be held for the beneficiaries.

- Trust structure is generally designed to protect the beneficiaries and minimize transfer taxes.
Slight Detour: Overview of Current Transfer Tax Regime

Additional Points:
1. Effective for individuals dying after 2011, **portability** provisions allow the second-to-die spouse to use any unused federal estate tax (but **not** GST tax or state estate tax) exemption of the first-to-die spouse.

2. The present $5.45 million exemption for estate, GST and gift taxes will be adjusted for inflation in 2017 and future years.

3. The Massachusetts estate tax exemption amount remains at $1 million, with no increases likely. Applied at graduated rates from 8% to 16%.

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Unlimited Estate Tax Marital Deduction

• Both Federal and Massachusetts estate tax laws allow an **unlimited marital deduction** for transfers to U.S. citizen spouses at death.

• Use of estate tax exemption **eliminates** tax.

• Marital deduction simply **defers** tax until the death of the surviving spouse.
Trust Structure on Death of First Spouse

On the death of the first spouse, his or her revocable trust will be divided into several separate trusts to achieve the following three key transfer tax objectives:

- Fully utilize the grantor’s federal and state estate tax exemptions
- Qualify for marital deduction to defer all estate taxes for as long as possible
- Maximize the use of GST exemption
Basic Marital Deduction Planning Structure

- **Family Trust** (aka Credit Shelter Trust): Will receive all of the assets that may pass free of federal and state estate tax upon the first spouse’s death.

- **Marital Trust**: Will receive the balance of the assets and may be further divided into multiple marital trusts to reflect any discrepancy between the federal and state estate tax exemption amounts.

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Revocable Trust
$8 million

Family Trust
$1 million

MA Marital Trust
$4.45 million

Federal + MA Marital Trust
$2.55 million
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Key Questions in Marital Deduction Planning

The marital deduction structure described above raises three key questions:

1. How do we calculate the amount passing to each trust to ensure the desired tax result?

2. How do we make the Marital Trusts eligible for the marital deduction?

3. How can a trust (in our examples, the MA Marital Trust) be eligible for the marital deduction for Massachusetts but not federal estate tax purposes?
Key Issues in Marital Deduction Planning

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   • The division between the Marital and Family Trusts is accomplished by means of a funding formula. In concept, the funding formula answers two questions:
     a) What is the amount that will be distributed to each trust?
     b) How should that target amount be funded?
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     a) What is the amount that will be distributed to each trust?
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   • There are two basic types of funding formulas, pecuniary and fractional.
     – A pecuniary formula is a gift of a specific amount of money. The key point is that the funding amount is fixed at the time of death, and will not change even as the estate increases or decreases in value after death.
     – A fractional formula is a gift of assets, to be divided among the recipients in various shares. The key point is that the funding amount will fluctuate as assets increase or decrease in value.
Key Issues in Marital Deduction Planning

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- Requirements for QTIP Trust to qualify for the estate tax marital deduction:

  1. The surviving spouse must be the sole beneficiary of the Marital Trust during his or her lifetime. (In contrast, the Family Trust can benefit anyone the Grantor chooses.)

  2. The surviving spouse must receive all of the income of the trust at least annually for his or her lifetime.

  3. QTIP election must be made on the decedent spouse’s estate tax return.

  4. The Marital Trust must address the issue of unproductive property

      o For example, can require the spouse’s consent to hold unproductive property, or give the spouse the right to compel the trustees to make the property productive
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  4. The Marital Trust must address the issue of unproductive property
     - For example, can require the spouse’s consent to hold unproductive property, or give the spouse the right to compel the trustees to make the property productive

• Each Marital Trust must be structured to qualify for the marital deduction.
Key Issues in Marital Deduction Planning

3. How can a trust (in our examples, the MA Marital Trust) be eligible for the marital deduction for Massachusetts but not federal estate tax purposes?
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- A Marital Trust that is structured as a QTIP Trust will only qualify for the estate tax marital deduction if an election is made on the first spouse to die’s estate tax return.
Key Issues in Marital Deduction Planning

3. How can a trust (in our examples, the MA Marital Trust) be eligible for the marital deduction for Massachusetts but not federal estate tax purposes?

- A Marital Trust that is structured as a QTIP Trust will only qualify for the estate tax marital deduction if an election is made on the first spouse to die’s estate tax return.
- Massachusetts allows a separate state-only QTIP election. DOR Directive 03-2.
Key Issues in Marital Deduction Planning

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- A Marital Trust that is structured as a QTIP Trust will only qualify for the estate tax marital deduction if an election is made on the first spouse to die’s estate tax return.
- Massachusetts allows a separate state-only QTIP election. DOR Directive 03-2.
- Thus, the personal representative has a great deal of flexibility to determine which Marital Trusts will qualify for which marital deduction.
Key Issues in Marital Deduction Planning

3. How can a trust (in our examples, the MA Marital Trust) be eligible for the marital deduction for Massachusetts but not federal estate tax purposes?

• A Marital Trust that is structured as a QTIP Trust will only qualify for the estate tax marital deduction if an election is made on the first spouse to die’s estate tax return.

• Massachusetts allows a separate state-only QTIP election. DOR Directive 03-2.

• Thus, the personal representative has a great deal of flexibility to determine which Marital Trusts will qualify for which marital deduction.
  – With respect to the MA Marital Trust, the personal representative will make a Massachusetts QTIP election, but will not make a federal QTIP election.
  – With respect to Marital Trust #2, the personal representative will make a QTIP election for both federal and Massachusetts tax purposes.
Example – Trust Structure on Death of First Spouse

Your clients, H and W, are a married couple who live in Massachusetts. Their total assets are $15,000,000. When the first spouse dies, they want the surviving spouse to receive all of the couple’s assets. On the death of the surviving spouse, they want all of their assets to pass to their two children (and their descendants).

Assumptions:

• Both H and W are U.S. citizens and residents of Massachusetts.
• H dies first with a taxable estate of $8,000,000.
• Neither H nor W made any taxable gifts during lifetime.
• All assets are located in Massachusetts.
Estate Plan For Married Couple

Transfer of assets at H's death (assuming he dies first)

Estate $8M

H's Revocable Trust:

Assumptions:
1. Federal estate tax exemption remains at $5.45m (indexed for inflation in 2016 and beyond).
2. MA estate tax exemption remains at $1m.

Family Trust $1M

Receives property equal to the maximum amount that may pass free of federal and MA estate taxes upon H’s death (i.e., currently $1m), reduced by the value of H’s lifetime taxable gifts.

Possible Beneficiaries: W and children (and more remote descendants). Could also benefit other family members.

Will pass estate tax free at W’s death.

Transfer of assets at W’s subsequent death

MA Marital Trust $4.45M

Receives property equal to the difference, if any, between the federal and the state estate tax exemptions (i.e., currently $4.45m), reduced by the value of H’s lifetime taxable gifts.

Beneficiary: Only W can be a beneficiary.

W must receive all of the income annually, and may receive additional distributions of principal in the Trustees’ discretion.

Will be included in W’s estate at her death for both federal and MA estate tax purposes.

Marital Trust #2 $2.55M

Remaining Estate.

Beneficiary: Only W can be a beneficiary.

W must receive all of the income annually, and may receive additional distributions of principal in the Trustees’ discretion.

Will be included in W’s estate at her death for both federal and MA estate tax purposes.

Decision Points:
- Creditor Protection
- Control over ultimate disposition
- Management of investments
- Tax Benefits
Estate Plan For Married Couple

Transfer of assets at H’s death (assuming he dies first)

Estate $8M

H’s Revocable Trust:

Assumptions:
1. Federal estate tax exemption remains at $5.45m (indexed for inflation in 2016 and beyond).
2. MA estate tax exemption remains at $1m.

Family Trust $1M

Receives property equal to the maximum amount that may pass free of federal and MA estate taxes upon H’s death (i.e., currently $1m), reduced by the value of H’s lifetime taxable gifts.

Possible Beneficiaries: W and children (and more remote descendants). Could also benefit other family members.

Will pass estate tax free at W’s death.

Transfer of assets at W’s subsequent death

MA Marital Trust $4.45M

Receives property equal to the difference, if any, between the federal and the state estate tax exemptions (i.e., currently $4.45m), reduced by the value of H’s lifetime taxable gifts.

Beneficiary: Only W can be a beneficiary.

W must receive all of the income annually, and may receive additional distributions of principal in the Trustees’ discretion.

Will be included in W’s estate at her death for MA estate tax purpose only.

Marital Trust #2 $2.55M

Remaining Estate.

Beneficiary: Only W can be a beneficiary.

W must receive all of the income annually, and may receive additional distributions of principal in the Trustees’ discretion.

Will be included in W’s estate at her death for both federal and MA estate tax purposes.

Decision Points:
- Creditor Protection
- Control over ultimate disposition
- Management of investments
- Tax Benefits

Will pass estate tax free.

Children

outright or in trust

Subject to Estate Taxation (after application of W’s remaining estate tax exemption amount)
Trust Structure After the Death of Both Spouses

• When both spouses have died, the Marital and Family Trusts can be combined into a single trust for the benefit of the grantor’s family members.

• At this point, there is virtually unlimited flexibility regarding the dispositive provisions.

• One popular approach is to divide the remaining trust property into separate shares for the grantor’s descendants, and keep each share in trust for as long as possible.

• Example:
  – On the death of the survivor of my spouse and me (the “date of division”), the Trustees shall divide any remaining property into shares for my descendants who are living on the date of division, by right of representation, and shall hold each share as a separate trust named for the person for whom it was set apart as provided in Article ___ below …
Example: Separate Shares for Descendants

• Typically, each separate share will be held as a discretionary trust for the benefit of that beneficiary and his or her descendants:
  – During the senior beneficiary’s life, the Trustees may make distributions from time to time to or for the benefit of one or more of the senior beneficiary and his or her descendants, equally or unequally and to the exclusion of any one or more of the beneficiaries, but giving primary consideration to the interests of the senior beneficiary.

• The beneficiary can be granted a limited power of appointment exercisable in favor of a particular class of beneficiaries (such as the grantor’s descendants)
  – In addition, the senior beneficiary can have a general power of appointment in order to reduce estate and GST taxes that may be due on the beneficiary’s death. These provisions can be complicated, and we won’t cover them in detail.

• Any unappointed property will be further divided into shares for the beneficiary’s own descendants, and the shares will continue to be held in trust on the same terms
Trustee Changes

• The instrument should provide a mechanism for appointing successor and additional trustees, and for removing trustees
  
  – The power to appoint successor and additional trustees is typically given to the grantor during life, and thereafter to some combination of the grantor’s spouse, other beneficiaries, and sitting trustees
  
  – The power to remove and replace the trustees is typically given to the grantor during life, and thereafter to the grantor’s spouse and/or other beneficiaries

• Consider granting appointment and removal powers only to beneficiaries who have reached a certain age, and requiring that the successor trustee be a professional trustee

• Retaining trustee appointment and removal powers can have adverse tax consequences. See Rev. Rul. 95-58.
  
  – To avoid estate tax issues, require successor and additional trustees to be independent (someone who is not related or subordinate to the powerholder within the meaning of IRC § 672(c))
Other Trustee Issues

• Consider specifying whether the trustees must act unanimously or may act by majority vote
  – Under MUTC § 703, the default rule is that co-trustees who are unable to reach a unanimous decision may act by majority vote. This rule applies only to instruments executed after the effective date of the MUTC (July 8, 2012).
  – Trustees of pre-MUTC trusts must act unanimously if trust instrument is silent

• Grant the trustees broad powers of administration
  – Under MUTC §§ 815-816, trustees have very broad administrative powers
  – Sometimes, however, it is useful to enumerate specific powers directly in the trust instrument (for example, powers related to life insurance)
Miscellaneous

• Include a spendthrift clause to protect beneficiaries after the grantor’s death
  – Must restrain both voluntary and involuntary transfers of beneficial interests. MUTC § 502.
  – No beneficial interest in any trust hereunder may be anticipated, alienated, or assigned by any beneficiary, nor may it be reached or applied by any claimant or creditor. This trust is intended to be a spendthrift trust.

• Describe mechanics of giving notice and accountings to beneficiaries
  – The MUTC contains several default notice provisions, most of which can be overridden in the instrument
  – Notwithstanding anything to the contrary contained in chapter 203E of the General Laws of Massachusetts or any similar law, the Trustees shall not be obligated to provide beneficiaries notice of the trust …

• Specify the governing law (Massachusetts), and consider including express provisions for changing the situs of administration
Termination

The instrument should address all possible ways in which the trust can be terminated:

1. By complete distribution to the beneficiaries:
   - Unless otherwise expressly provided, the authority to make distributions from principal includes the authority to distribute all of the principal, thereby extinguishing the remainder interests.

2. When all living beneficiaries have died:
   - If no descendant of mine is living on the senior beneficiary’s death, the Trustees shall distribute the trust property to the persons who would have inherited or succeeded to the same (and in the proportions in which they would have so inherited or succeeded) if I had then died the absolute owner thereof intestate, unmarried, without descendants and domiciled in Massachusetts.

3. When required by the Rule Against Perpetuities (MUPC § 2-901 et seq.):
   - Generally, 21 years after the death of a measuring life living on the grantor’s death (subject to a 90-year wait-and-see period)
   - Each trust hereunder shall terminate twenty-one years after the death of the survivor of those of my spouse, my descendants, and the natural persons referred to by name in this instrument and their descendants who are living on my death.