Flexibility in Trust Planning

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The recent tax reform efforts in Washington, D.C. (and in many state capitals) highlight the uncertainty that is inherent in long-term planning. Changes in income and transfer taxes are not the only unknowns that planners and clients need to take into account. The use of trusts for long-term planning can provide many benefits versus gifting assets outright, including enhanced asset protection and transfer tax protection through the use of the Generation Skipping Transfer (GST) exemption. However, merely placing assets in trust may not be enough. Other unknowns, such as changes in family needs and circumstances over time should also be considered when drafting an irrevocable trust for future generations.

Grantor Trust Flexibility

One of the primary reasons for establishing an irrevocable trust is to facilitate the transfer of wealth, generally to family members. Structuring a trust as a grantor trust can enhance the wealth transfer by allowing the assets to grow without the drag caused by income tax. A grantor trust is created when certain powers, commonly referred to as “grantor trust powers,” are retained by the grantor. The most common of these powers are the power of substitution, the power to borrow without adequate security, and the power to use income to pay premiums on insurance on the life of the grantor or the grantor’s spouse. By structuring a trust in this way, the grantor no longer owns the assets for gift tax purposes, but is still responsible for the income tax on trust income. This allows the trust assets to grow on a pre-tax basis, since the income tax is being paid by the grantor. An additional benefit of structuring an irrevocable trust as a grantor trust is that the income tax paid by the grantor is not considered an additional gift to the trust. Flexibility is crucial to maintaining a grantor trust over the lifetime of the grantor. As the trust grows over time, the grantor may be unwilling, or unable, to continue paying the income tax liability of the trust. If temporary relief of the tax liability is desired, consider granting the trustee the right to reimburse the grantor for income taxes attributable to trust income. This can keep the grantor trust status in place, but provide assets to the grantor to pay the income tax. While mandatory distributions to satisfy the grantor’s tax liability would cause the trust assets to be includible in the grantor’s taxable estate, distributions at the discretion of the trustee do not carry this risk. If a more permanent solution is warranted, the grantor trust status can be terminated altogether. This can be accomplished by the grantor relinquishing the powers that created the grantor trust in the first place. While it may be possible to turn the grantor trust status on again, this should be avoided since IRS has identified this as an area of potential abuse.


At the passage of EGTRRA in 2001, the elimination of the estate tax became a real possibility. Indeed, the repeal of the estate tax became reality, albeit “optional,” for decedents dying in 2010. As we got closer to 2010, estate plans began dealing with the uncertainty of estate taxes through the use of “what if” language that allowed for alternative disposition if the estate tax or GST tax is not in effect at the individual’s death. Recent legislative efforts in Washington have resurrected the possibility of repeal of the estate and GST taxes, underscoring the need to consider including alternative disposition provisions. Incorporating provisions that contemplate the presence or absence of what was once thought of as permanent can provide flexibility and serve as another means to communicate the grantor’s wishes.
Income Distributions and Access to Principal

The question of how much income and/or principal to make available to a beneficiary is a complex one. While ongoing access to income is a relatively straightforward decision (mandatory distributions vs. trustee discretion), a beneficiary’s need to access principal is something that is apt to change over time. Therefore, flexibility with regard to principal is something that should be considered. While some trusts can prohibit access to principal, many trusts contemplate the fact that income distributions may not be sufficient to provide adequate support. This is especially important when considering the low income yields of today’s market and the impact of the prudent investor rule for fiduciaries.

The most common way to grant access to principal is through distributions at the discretion of the trustee. While this discretion can be limited to an ascertainable standard—such as health, education, maintenance, and support—some trusts grant an independent trustee full discretion to make distributions for any purpose. Still another way to grant access to principal is through a unitrust provision, sometimes referred to as “deemed income.” A unitrust provision can provide additional flexibility in trust management. By doing this, the trust treats the unitrust amount, whether a set amount or a set percentage of assets, as trust income for distribution purposes. A unitrust distribution lessens the need to manage the trust for current income at the expense of long-term principal growth. Alternatively, a trustee may exercise a power to adjust between income and principal where the trustee hasn’t been given the power to distribute beyond trust income.

Rights of Withdrawal

In addition to mandatory and discretionary distributions, trusts can also grant beneficiaries the right to withdraw trust assets. This right can cover the entire trust corpus or it can be limited in amount. Examples include an annual right to withdraw a stated amount of principal or the right to withdraw up to a certain percentage of trust assets. These rights can be exercisable immediately, upon the occurrence of a specified event (such as age 35), or subject to approval by a third party (generally the trustee or trust protector). These rights provide additional flexibility for the beneficiary, as the need to justify discretionary distributions are often felt to be burdensome. Care should be taken in drafting these rights. An unexercised right of withdrawal will cause the assets subject to the right to be includible in the beneficiary’s taxable estate and may decrease the asset protection afforded to the assets held in trust.

Powers of Appointment

Trust provisions should reflect the grantor’s wishes regarding disposition of trust assets, but sometimes these provisions may not meet the changing needs and circumstances of future beneficiaries. Incorporating powers of appointment can allow the beneficiaries to make the adjustments necessary to meet the changed needs of the beneficiary and his/her family. For instance, a beneficiary with one financially successful child may want to steer assets toward another child who has a greater need. These powers can be exercisable during the beneficiary’s lifetime (lifetime power) or exercisable only after the beneficiary’s death (testamentary power). These powers can also be either general powers or limited powers (described below).

Powers of appointment can be as broad or as narrow as the grantor wishes. A limited power cannot contain the right to appoint assets to any of the following:

1. The powerholder
2. The powerholder’s estate
3. Creditors of the powerholder
4. Creditors of the powerholder’s estate

These appointees are sometimes referred to as “the forbidden four.” Exercising a limited power generally has minimal income tax or estate tax implications for the powerholder. For this reason, limited powers are more commonly used in trusts.

A general power is in many ways identical to a limited power, but must contain the right to appoint assets to at least one of the “forbidden four.” Unlike a limited power, granting a general power causes the assets covered by the power to be included in the powerholder’s taxable estate, whether the power is exercised or not. It should be noted that a power of appointment does not have to be exercisable for the entire trust, but can cover only a portion of trust assets.

As discussed above, the absence of estate tax implications make limited powers more commonly used than general powers. In some circumstances however, it can be beneficial...
to grant a beneficiary a general power and cause assets to be included in a beneficiary’s taxable estate, particularly in the realm of GST protection. Conveying a limited power of appointment can keep assets out of a beneficiary’s taxable estate, but unless GST exemption is allocated to trust assets, assets passing to a skip person will incur a GST tax, which is similar to the estate tax. Therefore, granting a limited power of appointment to a child in a GST-nonexempt trust may not be as tax efficient as it appears, particularly if the beneficiary does not have a large enough estate to incur an estate tax liability. In situations like this, granting a contingent general power of appointment, limited to the beneficiary’s remaining estate or GST exemption (whichever is less), may save taxes by allowing some (or all) trust assets to be included in the beneficiary’s estate. This power can protect assets for future generations without imposition of additional transfer tax. If the possibility of appointing assets away from the family is a concern, the general power should be limited to creditors of the beneficiary’s estate. While notice of the general power should be given to the beneficiary, it is not necessary to exercise the general power to cause estate inclusion.  

**Trust Situs**

Significant consideration is usually given to the impact of legislative changes on the federal level; however, the impact of state laws and state income taxes on nongrantor trusts generally receives less attention. This is unfortunate, particularly when one recognizes that trust situs can be changed. Americans are, by and large, a pretty mobile group. People move for jobs, education, or just for environment and lifestyle. Over time, it’s not uncommon to have some (or all) trust beneficiaries living in other states (or countries). It may not be beneficial to have income from the trust subject to state income tax if it can be avoided. Likewise, moving the trust situs to a state that has more beneficial trust statutes, such as asset protection or beneficiary disclosure rules, can also be beneficial in certain instances. State trust law is evolving on a regular basis, and the impact of a trust’s governing law should be considered in light of these changes. While frequent changes to trust situs is not a good idea, granting the trustee or trust protector the power to change the trust situs is an important (and often overlooked) consideration.

**Trust Protector**

The use of a trust protector to add flexibility to a trust is becoming a more widely accepted practice. A trust protector is an individual who is granted powers under the trust instrument to ensure the grantor’s intentions are carried out after death and to ensure the trust is not adversely affected by regulatory changes or other unforeseen circumstances. Typically, this person is not “related or subordinate” to the grantor or any of the beneficiaries because there could be transfer tax consequences. While the trust protector is not a fiduciary, the trust protector can function as the “conscience of the trust,” ensuring that the grantor’s wishes and intent are carried out. The powers granted a trust protector can be broad and vary from state to state, depending on state law. In general, some common powers include the power to terminate the trustee, appoint successor protectors, direct or veto trust distributions, and add or remove beneficiaries.

The trust document should explicitly state the powers granted to the trust protector and be clear about the relationship between the trust protector and the trustee. The role of the trust protector and trustee should not overlap. Giving too many powers to the trust protector can put the trust protector at risk of being deemed a de facto co-trustee and with that comes all the fiduciary responsibility. For this reason, it is highly recommended that you consult with legal and tax advisors to evaluate whether naming a trust protector would be advantageous based on your estate plan and, if so, who should be named trust protector.

**Decanting the Trust**

Flexibility is important to consider when establishing new trusts. How can one build flexibility into existing trusts? While the ability to change the terms of an existing irrevocable trust may be limited, it may be possible for the trustee to change the trust through a process known as decanting. The term “decanting” takes its name from the process of pouring wine from one vessel to another. Similarly, decanting a trust distributes the assets from the existing trust into another trust. Many states now have decanting statutes of their own, and a number of states have enacted or are expected to enact the Uniform Trust Decanting Act, which seeks to increase consistency among state laws regarding decanting. Because decanting is dependent on state law, you should contact your legal advisor to determine if trust decanting is right for you.

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