

# Price & Farrington's Estate and Tax Planning FastFacts

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Estate, Tax and Family Wealth Planning for Advisors and Clients

Price & Farrington, PLLC

Attorneys and Counselors at Law

12501 Bel-Red Road, Suite 215

Bellevue, Washington 98005

425-451-3583

Email: [contact@pricefarrington.com](mailto:contact@pricefarrington.com)

## The Inheritor's Trust: A 21st Century Estate Planning Tool

Jane Dough was getting over the recent death of her mother and could hardly enjoy her million dollar inheritance. Jane's mother's trust was like most trusts that make mandatory outright distributions to the child upon reaching a specified age. Since Jane had already attained the age specified in the trust agreement, the trustee transferred the trust assets to Jane outright and free of trust. Jane's mother had directed her attorney to draft the trust to give Jane her inheritance outright because Jane was responsible and capable of handling her inheritance without any help.

**The rub.** Unfortunately, just a few years later, Jane's marriage fell apart and her husband John Dough filed for a **divorce**. To make matters worse, Jane was a defendant in a multi-million dollar **lawsuit** because of a car accident she had caused. Her attorney was able to negotiate a favorable divorce settlement, and her insurance covered much of the lawsuit settlement. Jane was happy to have \$200,000 left after both of these problems, especially after her attorney

told her that she could have been left with nothing.

In a perfect world, none of our client's descendants will ever go through a divorce or a lawsuit or a **bankruptcy**. But this perfect world doesn't exist. Let's take a look at a concept called the **Inheritor's Trust** that, if implemented by Jane Dough and her mother, would have protected Jane's entire million dollar inheritance.

**Inheritor's Trust.** Many times a Baby Boomer client has parents who have a fair amount of money. If the parents simply leave their money to the child as an outright gift under the parents' wills or living trusts, that money will be includible in the child's taxable estate and also be subject to his or her creditors, a divorcing spouse or some other "predator". This is not the most effective way for the parents to transfer their estate with maximum protection.

One option is for the child to go to his/her parents and suggest they go back to their lawyer and pay a hefty fee to draft up a trust to hold the child's inheritance. But the parents might be reluctant to pay that money, or don't want to focus on the complexities of the trust and simply keep putting it off.

A better idea is for the **child** to hire his or her **own** attorney to draft the trust instrument so that it contains provisions beneficial to the child. After this is done, the child — let's call her Debbie DePew — can go back to her parents and say: "I'd like you to go to your attorney and make this simple change. I want you to add the following sentence to your wills (or living trusts, as the case may be): ***Notwithstanding anything in this instrument to the contrary, any time a distribution is***



Charles P. Farrington and Glenn D. Price

***indicated to my daughter, Deborah DePew, it shall instead be payable to the Deborah DePew Irrevocable Trust Dated March 25, 2009, to be held as provided therein.***"

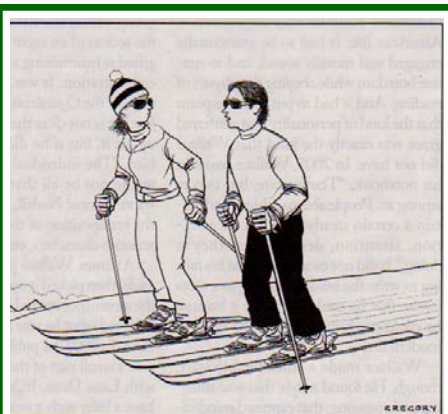
Because it is simple and won't cost the parents a lot of money to have the attorney do it, and it doesn't take much time or involvement on the parents' part, they are much more likely to accomplish this small change.

The inheritance will now flow directly into the trust the child created and have the following benefits:

- It will be excluded from the child's taxable estate.
- It will be outside the child's probate estate.
- It will be protected from lawsuits, creditors and divorcing spouses.
- It can still be controlled and managed by the child, who can serve as trustee (although even greater protection will result if the child is not the trustee or serves as a co-trustee).
- It can still allow the child to decide how the remaining trust assets will pass after the child's death.

In other words, by having the child set up the trust, but having the

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***"Sure, I play hard,  
but I also inherit hard."***

parents fund it via a very small change in the provisions of the parent's will or living trust, the child can still receive the inheritance, but in a form that will protect it and likely enhance its value over the years.

The Inheritors's Trust is a special type of dynasty trust *designed by the inheritor to receive an inheritance that would otherwise have been passed outright* as a result of inferior single generation planning by the attorney for the future decedent (i.e., the parent).

In its simplest structure, the Inheritor's Trust can be designed with the inheritor as the *sole trustee* with the right to any or all of the trust's income, plus access to principal limited to health, education, maintenance and support. In

most cases, however, this approach isn't recommended because *greater flexibility, tax benefits and creditor protection can be achieved with a co-trustee arrangement. Note: A creditor of a beneficiary who is the sole trustee can likely reach as much as the trustee-beneficiary could properly distribute to him- or herself under the terms of the trust agreement.*

**Two trustees.** The inheritor is either the sole trustee or, better, is a *co-trustee* with the ability to remove the other co-trustee and select a *successor co-trustee*. Control of the trusteeship is coupled with a *broad nongeneral power of appointment* that can have the effect of eliminating any potential interference by *remote beneficiaries* (e.g., the inheritor's children and/or others). Because the inheritor has the ability to eliminate all participation in the enjoyment of the trust assets by secondary and remote beneficiaries, they won't be inclined to interfere with the inheritor's decisions as trustee because their rights could be eliminated.

The superior version, then, is designed with two trustees —the *primary beneficiary (i.e., the inheritor) as the investment trustee*, and an independent trustee, such as the *inheritor's best friend or perhaps a corporate fiduciary, as the distribution trustee*. The inheritor can be given the power to remove and replace the trustees, thereby maintaining the beneficiary-controlled feature of this trust design, as long as the replacement distribution trustee is not a *"related or subordinate party"* as defined in IRC § 672(c). Because this strategy creates a nearly insurmountable asset and divorce protection shield, the trust should be designed to continue for *multiple generations* so that the down-line beneficiaries enjoy the same benefits.

By using a friendly independent trustee, certain powers can be drafted into the trust agreement that could not be granted if there was no independent trustee. This is because *certain powers that can be given to an independent trustee would cause tax*



*and creditor problems if given to a beneficiary who is also serving as trustee.* An independent co-trustee is generally acceptable to clients once they realize that the inheritor can have broad *removal and replacement powers* as long as the replacement trustee is not a "related or subordinate party".

**Immediate funding.** A common feature is to have the future decedent (i.e., generally the inheritor's parent or grandparent) fund the Inheritor's Trust with a substantial gift before death. The amount might be as little as \$1000 or it might be a much larger amount. If the trust is funded with a gift now, the inheritor can make use of the trust immediately until having to wait until the grantor's death. When one considers the significant benefits of the trust as described in this article, the reasons to fund it immediately are obvious.

There are also several advanced uses for the Inheritor's Trust, which we won't discuss here. It's definitely a 21st century tool worth considering. ■

*Trust planning is the estate planning attorney's most effective and versatile tool. When designed and implemented appropriately, a trust's power is formidable. We're here to help. GDP*

**Celebrating the Abraham Lincoln Bicentennial in 2009**



*"Long Abraham Lincoln a Little Longer" Year: 1864. This cartoon by Frank Bellow, Harper's Weekly, celebrates Lincoln's re-election, depicting the tall president having grown taller in political stature.*

