COMMITTEE REPORT: ESTATE PLANNING & TAXATION

ELECTRONICALLY REPRINTED FROM DECEMBER 2016

TRUSTS & ESTATES

The WealthManagement.com journal for estate-planning professionals

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Depression-Era Trusts Come Home To Roost

Consider six issues to help families prepare for termination

During the 1930s, there was a spike in the number of trusts created as wealthy families responded to steep increases in federal gift and estate tax rates. These trusts are now approaching mandatory termination dates and, as with any trust termination, advisors must consider how best to help beneficiaries prepare for a new influx of wealth.

Much focus has been placed on the implications of wealth transfer between members of the Baby Boomer generation and their heirs. For certain families, there may be a more pressing task at hand—many dynasty trusts that date back to the Depression Era are on the cusp of expiring, putting the classic tasks of estate planners into fascinating historical context.

As noted in *A History of Federal Estate, Gift, and Generation-Skipping Taxes*:

> The depression of the 1930s reduced income tax revenues and increased the demand for revenues to finance various new Government projects …Congress turned to the estate and gift taxes. The Revenue Act of 1932 increased the estate tax rates at virtually every level, added two new rate brackets, and reduced the estate tax exemption to its 1924 level of $50,000 … The Revenue Act of 1934 raised the maximum estate tax rate to 60 percent, on a net estate over $10,000,000.[1]

Tax law reform can influence human behavior, a phenomenon we all experienced in 2012, when many wealthy individuals funded irrevocable trusts in response to the threat of the estate and generation-skipping transfer tax exemptions reverting to $1 million. There was a similar spike in trust creation during the 1930s and early 1940s.

Internal Revenue Service statistics illustrate this trend. In 1933, there were 1,710 gift tax returns filed. From 1936 to 1942, an average of over 18,800 gift tax returns were filed annually, with over 30,000 filed in 1942 alone.[2]

Both the common law and state laws traditionally limited how long a private trust could run. They did so by imposing rules against perpetuities, mandating that these trusts have provisions setting forth a maximum duration date for the final distribution of the trusts. Generally, this final termination date would relate to the lifespan of individuals or groups of people, then living, plus 21 years, although some of these trusts don't add the 21-year period. Today, those youngest family members from the 1930s are approaching their 90s or have already passed away. As a result, some of these trusts are on the eve of termination; others have several years remaining; and the rest will terminate within one to three decades. Thus, the time has come for heirs and their counselors to prepare for the expiration of these trusts.

Advisors should consider the following six issues as trusts approach termination.

Review Trust Terms

While it may seem rudimentary, identifying the beneficiaries is critical and isn't always as straightforward as it may seem. The first step is to determine which state's laws govern the trust for purposes of construction and validity, as this will determine the definition of terms such as "issue" and "per stirpes." Older trust instruments don't always contain governing law clauses, but even a governing law clause may not be determinative because a prior trustee may have transferred the trust to a new state. This transfer typically would change only the state law governing the trust's administration, not construction and validity, but state laws may vary, so practitioners should confirm the law in their state.

One example of how determining the beneficiaries can affect termination is the issue of whether an adopted child is to be included as a remainder beneficiary. These laws vary by state and, in some cases, vary even within states. For instance, because of changes to Massachusetts law over time, whether the term "issue" in a Massachusetts trust includes adopted children will depend on when the trust was executed.

It also will be necessary to consider how the revolution in reproductive technology will affect the class of remainder beneficiaries. For example, this past year saw the first child born with DNA from three biological parents.[3]

Manage Beneficiary Expectations

While sudden, significant wealth can disrupt the stability of a family, education and planning can mitigate against this risk. The advisors should consult with the beneficiaries of soon-to-be expiring trusts to make sure they have an accurate understanding of the provisions of the trusts. This is particularly so when what might seem to be an arbitrary legal distinction (per stirpes distribution vs. per capita) leads to what some family members might perceive as an anomalous result—such as

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half of a trust being divided among five brothers and sisters, with the other half passing entirely to their only child cousin. Discussing this result with the family ahead of termination will not only give the beneficiaries time to deal with disparity emotionally, but also may afford opportunities to address equalization strategies. For instance, if the trust allows for discretionary non-pro rata distributions, the trustee might consider distributing principal to beneficiaries who'll receive a smaller portion of the remainder. Or, senior generations of the family might consider adjusting their estate plans to equalize for the differences stemming from the terminating trust.

Setting beneficiaries' expectations regarding their new wealth is also advisable. For example, some may not fully appreciate the extent to which their new income tax burden will curtail their free cash flow after termination or how quickly principal can be eroded when expenses exceed income. Education here may help ward off spending sprees made in anticipation of trust termination or other unwise financial decisions. It's also helpful to set beneficiaries' expectations as to timing because many assume that the assets will be delivered to them on the day of termination.

With some exceptions, assets held in trust for a beneficiary are protected from the beneficiary's creditors.

Make Tax Planning Efficient

Beneficiaries of soon-to-expire trusts will need to focus on their expectancies within the context of their overall estate plans. This can be illustrated in a number of different ways:

- A 60-year-old individual with four children and a net worth of $5 million who might not otherwise feel ready to make annual exclusion gifts could reconsider, once armed with the knowledge that he'll be receiving an additional $10 million from an expiring trust in 10 years.
- A married couple for whom I-love-you wills, which leave all property outright to the surviving spouse, would otherwise be sufficient might consider executing documents that address state estate taxes if an upcoming trust distribution will significantly augment their assets.
- In some cases, it might make sense to distribute low income tax basis assets to an elderly beneficiary so that the distributed assets receive a basis step-up for income tax purposes at his death.

Consider Creditor Protection

With some exceptions, assets held in trust for a beneficiary are protected from the beneficiary's creditors. If it's important to a beneficiary to maintain creditor protection, he may wish to consider transferring the distributed assets to a self-settled asset protection trust (only allowed in certain jurisdictions). Other options would include the use of limited liability companies (LLCs) to hold distributed assets or immediately and irrevocably transferring the distributed assets into a trust for a spouse or descendants.

Protect Beneficiary From Himself

Sometimes, a remainder beneficiary isn't ready to handle a large influx of money responsibly. In that situation, the trustees may be able to effectively extend the trust term by decanting the trust (essentially paying the trust assets to a new trust without the mandatory payouts) in accordance with either express permission to do so in the trust instrument or authority granted under state law.

Notably, when a trust is terminating due to having reached the applicable perpetuities period (as will usually be the case with 1930s trusts), decanting isn't an option. There are still, however, some steps worth considering.

One vehicle that can address concerns about a beneficiary's readiness is an arm-twisting trust, in which parents may persuade the beneficiary to immediately contribute the received assets into a trust that requires parental (or another's) consent for distributions. Of course, this method would depend on the cooperation of the beneficiary, which may present a roadblock.

Another option, if the trust agreement allows it, would be to bypass the beneficiary in question by making discretionary distributions to other beneficiaries before termination. This option could be coupled with an equalization adjustment to senior generation members' estate plans that leaves assets to the beneficiary in question in trust, rather than outright.

The trustee might also consider transferring trust assets into an entity (such as an LLC) with a third-party manager, so that ultimately the beneficiary receives interests in an entity with a management structure, distribution control and transfer restrictions already in place.

Plan With Specific Assets in Mind

Many trusts are invested in private equity and hedge funds that require subscription agreements and often have stringent requirements as to who's allowed to invest. For example, they may require that owners be qualified investors under the Investment Company Act of 1940. The change in ownership may require the unwinding of the investment altogether.

Other trusts may hold real property that will need a framework for post-distribution management. In this instance, it will likely be prudent to develop an agreement among the ultimate owners prior to the trust's termination so that a plan is in place for decision making, governance and use.

Endnotes

1. *www.naepc.org/journal/issue01f.pdf.*
2. *See* David Joulfaian, OTA Paper 100, Table 8, at p. 46, *The Federal Gift Tax: History, Law, and Economics* (November 2007).
3. *www.forbes.com/sites/emilywillingham/2016/09/28/controversy-erupts-around-baby-with-three-biological-parents/#a579d5b77a1e.*