

# 33rd Annual Tax Symposium

## **APPOINTING THE BENEFICIARY AS TRUSTEE**

### **WAIT, WHAT?!?**

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#### I. OVERVIEW

- A. A typical estate plan includes the following:
  - 1. Revocable trust.
  - 2. Last will and testament.
  - 3. General power of attorney.
  - 4. Medical power of attorney.
  - 5. Ancillary documents such as a HIPAA release, assignment of tangible personal property to trust, tangible personal property memorandum, etc.
- B. For a revocable trust, the client will be the initial trustee, but someone will need to take over as trustee on the client's death or incapacity.
- C. The successor trustee has a lot of responsibilities.
  - 1. Collecting, investing, and protecting assets.
  - 2. Identifying and paying debts.
  - 3. Paying expenses of administration.
  - 4. Identifying, providing legal notices to, interacting with, and making distributions to beneficiaries.
  - 5. Preparing accountings.
  - 6. Filing tax returns.

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- D. Selecting a successor trustee is an integral, and often difficult, part of the estate planning process.
  - 1. Clients must have a great deal of faith in the trustee.
    - a. Trustworthy.
    - b. Reliable.
    - c. Detail oriented.
    - d. Financially savvy.
    - e. Good interpersonal skills.
  - 2. Clients often don't want to upset children and other family members.
    - a. "I feel like I need to appoint Susan because she's the oldest child, but if I don't appoint Johnny, he will lose it and make Susan's life miserable!"
    - b. Given the amount of work and stress involved, I often tell clients the appointment of the trustee is a burden, rather than an honor.
- E. The same holds true for any irrevocable trust created by the client.
  - 1. For irrevocable trusts, clients generally must give up all control regarding who receives what and who is in charge of what, lest the irrevocable trust assets get included in the client's taxable estate upon death.
  - 2. A client can retain the right to remove and replace trustees of an irrevocable trust, although great care must be taken to avoid having the trustee powers imputed to the client. In that case, the trust assets are taxed in the client's estate.

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## II. TYPICAL STRUCTURE

- A. Ultimately, clients must decide when and how children (and any other beneficiaries) will receive the inheritance.
- B. For grown beneficiaries, this is somewhat easier because the client can assess how mature and responsible the beneficiary is (or is not).
- C. For younger beneficiaries, this is obviously more difficult, and the client must look into a crystal ball and make an educated guess about what will be appropriate for the beneficiaries years or decades in the future.
  - 1. A typical approach can include the following:
    - a. Periodic distributions:
      - i. Beneficiary receives income and principal for health, education, maintenance, and support.
      - ii. Beneficiary may receive distributions for purchasing a residence, getting married, or starting a business.
      - iii. Beneficiary may receive additional distributions in the trustee's discretion.
    - b. Outright distributions:
      - i. Beneficiary receives all income beginning at age 21.
      - ii. Beneficiary receives outright distributions of principal in one-third installments at ages 25, 30, and 35.

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- iii. If the beneficiaries are older, maybe the outright distributions of principal are tied to the client's date of death – e.g., one-third immediately, one-third five years later, and the balance ten years later.

## III. TREND TOWARD LIFETIME TRUSTS

- A. Financial planners and attorneys are trending away from the typical structure.
- B. Instead, a beneficiary's inheritance is held in a continuing, lifetime trust.
  1. No mandatory distribution ages/events.
  2. Purely discretionary distributions.

## IV. WHY WOULD A CLIENT WANT TO DO THIS?

- A. Creditor protection.
- B. Leverage of federal gift, estate, and generation-skipping transfer tax exemption.
- C. While there are administrative costs (e.g., preparing and filing income tax returns annually), the benefits can be significant.

## V. WHO WILL BE TRUSTEE OF THIS LIFETIME TRUST?

- A. A lifetime trust makes the selection of a trustee even more difficult.
  1. For younger beneficiaries, the trustee is typically older, perhaps a generation older, than the beneficiary.
  2. If a lifetime trust is used, who is going to be around when the beneficiary is age 85?
  3. If a lifetime trust is used, who is going to want to be trustee when the beneficiary is age 85?

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- B. A bank or trust company is often used.

## VI. CAN THE BENEFICIARY BE TRUSTEE?

- A. Short answer is yes.
- B. Correct answer is yes, but...

## VII. CREDITOR ISSUES

- A. Michigan law provides significant creditor protection for assets held in trust.
- B. That protection starts with the trust's "spendthrift" provision.

- 1. MCL 700.7502.

- a. A term of a trust providing that the interest of a trust beneficiary is held subject to a "spendthrift trust," or words of similar import, restrains both voluntary and involuntary transfer of the trust beneficiary's interest.
- b. With limited exceptions (e.g., child support, spousal support, and governmental claims), a beneficiary's interest in a trust may not be transferred in violation of a valid spendthrift provision and trust property is not subject to enforcement of a judgment until distributed directly to the trust beneficiary.
- c. In short, a beneficiary's creditors generally cannot reach assets held in the trust.

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- d. Sample language - “No beneficiary may assign, anticipate, encumber, alienate, or otherwise voluntarily transfer the income or principal of any trust created under this trust. In addition, neither the income nor the principal of any trust created under this trust is subject to attachment, bankruptcy proceedings or any other legal process, the interference or control of creditors or others, or any involuntary transfer.”
- C. Then see whether the trust is a support trust or a discretionary trust.
- D. Support trust.
1. Definition. MCL 700.7103(k)
    - a. "Support provision" means a provision in a trust that provides the trustee shall distribute income or principal or both for the health, education, support, or maintenance of a trust beneficiary, or language of similar import. A provision in a trust that provides a trustee has discretion whether to distribute income or principal or both for these purposes or to select from among a class of beneficiaries to receive distributions under the trust provision is not a support provision, but rather is a discretionary trust provision.
    - b. This is a narrow definition.
    - c. Sample language - “The trustee shall distribute net income and principal of the beneficiary’s separate trust for the beneficiary’s health, education, maintenance, and support.”
  2. Protection for support trust. MCL 700.7503.

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- a. The interest of a beneficiary that is subject to a support provision may not be transferred and the trust property is not subject to the enforcement of a judgment until income or principal, or both, is distributed directly to the trust beneficiary. After a distribution to a trust beneficiary whose interest is subject to a support provision, the income and principal distributed are subject to the enforcement of a judgment only to the extent that the income or principal, or both, is not necessary for the health, education, support, or maintenance of the trust beneficiary.
  - b. The use or enjoyment of trust property by a trust beneficiary whose interest is subject to a support provision may not be transferred and is not subject to the enforcement of a judgment against the trust beneficiary.
3. Limitations on protection for support trust. MCL 700.7507.
- a. Whether or not a trust contains a spendthrift provision, a creditor or assignee of a trust beneficiary may reach a mandatory distribution of income or principal, including a distribution upon termination of the trust, if the trustee has not made the distribution to the trust beneficiary within a reasonable time after the designated distribution date.

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- b. "Mandatory distribution" means a distribution of income or principal that the trustee is required to make to a trust beneficiary under the terms of the trust, including a distribution upon termination of the trust. Mandatory distribution does not include a distribution subject to the exercise of the trustee's discretion even if either of the following applies:
  - i. The direction is expressed in the form of a standard of distribution.
  - ii. The terms of the trust authorizing a distribution use language of discretion and language of direction.

## E. Discretionary trust.

### 1. Definition. MCL 700.7103(d).

- a. "Discretionary trust provision" means a provision in a trust, regardless of whether the terms of the trust provide a standard for the exercise of the trustee's discretion and regardless of whether the trust contains a spendthrift provision, that provides that the trustee has discretion, or words of similar import, to determine 1 or more of the following:
  - i. Whether to distribute to or for the benefit of an individual or a class of beneficiaries the income or principal or both of the trust.
  - ii. The amount, if any, of the income or principal or both of the trust to distribute to or for the benefit of an individual or a class of beneficiaries.
  - iii. Who, if any, among a class of beneficiaries will receive income or principal or both of the trust.



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- iv. Whether the distribution of trust property is from income or principal or both of the trust.
  - v. When to pay income or principal, except that a power to determine when to distribute income or principal within or with respect to a calendar or taxable year of the trust is not a discretionary trust provision if the distribution must be made.
- b. This is a broad definition.
  - c. Sample language - “The trustee may, but shall not be required to, distribute to or for the benefit of the beneficiary so much, all, or none of the net income and principal of the beneficiary’s separate trust as the trustee may determine in the trustee’s sole, absolute, and uncontrolled discretion.”
2. Protection for discretionary trust. MCL 700.7505.
- a. The transferee or creditor of the beneficiary of a discretionary trust provision does not have a right to any amount of trust income or principal that may be distributed only in the exercise of the trustee’s discretion, and trust property is not subject to the enforcement of a judgment until income or principal, or both, is distributed directly to the trust beneficiary.

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3. Limitations on protection for support trust. MCL 700.7815.
  - a. A beneficiary of a discretionary trust provision has no property right in a trust interest that is subject to a discretionary trust provision, and has no right to any amount of trust income or principal that may be distributed only in the exercise of the trustee's discretion. However, notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute," "sole," or "uncontrolled," a trustee abuses the trustee's discretion in exercising or failing to exercise a discretionary power if the trustee does any of the following:
    - i. Acts dishonestly.
    - ii. Acts with an improper motive, even though not a dishonest motive.
    - iii. Fails to exercise the trustee's judgment in accordance with the terms and purposes of the trust.

## VIII. TAX ISSUES

- A. Income tax considerations are not critical when determining the advisability of appointing the beneficiary as trustee.
  1. Trust income that is retained by the trust is generally taxed to the trust itself.
    - a. However, if the trust is a "grantor trust" as to the beneficiary, all income and deductions of the trust are picked up on the beneficiary's Form 1040, regardless of whether there are distributions.

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2. Trust income that is distributed to the beneficiary is generally taxed to the beneficiary.
  - a. However, capital gains are generally taxed to the trust even if “distributed” to the beneficiary, unless the trustee has authority regarding the allocation of receipts between principal and income.
- B. Gift tax considerations are not critical when determining the advisability of appointing the beneficiary as trustee.
  1. Unless there are multiple beneficiaries of the trust.
    - a. E.g., a trust for the benefit of the beneficiary and the beneficiary’s descendants.
  2. If there are multiple beneficiaries, be careful to avoid having distributions to the other beneficiaries treated as gifts by the trustee/beneficiary.
- C. Depending on the level of wealth involved, estate tax considerations can be vital when determining the advisability of appointing the beneficiary as trustee.
  1. Distributions must be limited to ascertainable standards.
    - a. Health, education, maintenance, and support (“HEMS”).
    - b. Broader language provided in the treasury regulations, if the drafter is feeling adventurous.
  2. Otherwise, the beneficiary is deemed to have a general power of appointment, which results in the trust assets being included in the beneficiary’s taxable estate on the beneficiary’s death.

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## IX. CONTROL/PRACTICAL ISSUES

- A. The same analysis in selecting a trustee must be undertaken with respect to the beneficiary.
  - 1. Age.
  - 2. Maturity.
  - 3. Financial acuity.
  - 4. Business skills.
  - 5. Marital status.
  
- B. If the beneficiary passes that analysis, the client then has to determine whether the beneficiary will be willing to “play ball.”
  - 1. Will the beneficiary/trustee actually follow the terms of the trust?
    - a. “I know what Mom and Dad were thinking when they set things up this way, but I’m cool – I’m just going to take everything out.”
  - 2. Spouses can have a significant impact on this.
    - a. “Your parents controlled you your entire life. Are you going to continue to let them control you now that they’re dead?”
  - 3. All creditor protection and all tax advantages can be wiped out in an instant.

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- C. Can we appoint a co-trustee with the beneficiary?
  - 1. If the co-trustees can act independently of each other, this will be of limited utility from a control standpoint.
  - 2. If the co-trustees must act unanimously, that alone may not solve estate tax problems.
  
- D. Instead of appointing the beneficiary as trustee, can we appoint a third-party trustee and give the beneficiary the power to remove and replace the third party?
  - 1. If a HEMS standard is used, the power to remove and replace should not cause adverse tax consequences.
  - 2. If anything other than a HEMS standard is used, the power to replace should be limited to trustees that are not “related or subordinate” to the beneficiary.
  
- E. How will the IRS view this?
  - 1. If a HEMS standard is used and actually followed by the beneficiary/trustee, the structure should be respected.
  
- F. How will a judge view this if a creditor comes knocking?

## X. LET'S DISCUSS WITH THE MADDIN HAUSER LITIGATION TEAM.