

**ESTATE PLANNING AND DRAFTING
FUNDAMENTALS**

DRAFTING TRUSTS

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APPENDIX A: Estate Planning Forms and Commentary, Introduction to Model Form Book and Annotation of Model Form © 2002., by Susan T. Bart, Timothy G. Carroll, Robert E. Hamilton, Louis S. Harrison and Donna E. Morgan.

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ESTATE PLANNING AND DRAFTING FUNDAMENTALS

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I. Background and Issues of Definition

A. Trusts

A trust is an obligation arising out of a confidence reposed in a person, for the benefit of another, to apply property faithfully and according to that confidence. 4 Horner Probate Prac. & Estates § 2431. Thus, a trust is like a contract or agreement between two parties, the person who creates the trust, and the person or entity appointed to oversee the management of the trust. The trust is a vehicle which is designed to hold property for the benefit of designated beneficiaries.

Corporate trustees are not inexpensive, but interestingly, as the law of trusts first developed in England, the position of trustee was regarded as one of such high honor and altruism, the trustee was never permitted to use the position for personal gain, not even to the extent of reasonable compensation for his own time and services. This rule has been modified in the United States and a trustee is now allowed fees for his services; but this is contingent upon his performance of his duties with diligence, honesty and good faith. *Sauvage v. Gallaway*, 80 N.E.2d 553,558 (1948)

B. Parties to the “Contract”

1. The Grantor [Synonyms include Settlor, Trustor, and Donor]. The grantor is the person who creates the trust, and whose assets will be subject to management pursuant to the terms of the trust.
2. The Trustee. The trustee is the fiduciary charged with managing the trust assets in accordance with the terms of the trust. The trustee has legal title to the trust property. The trustee has a fiduciary relationship with the beneficiary of the trust and cannot deal with the subject matter of the trust for his or her own benefit. 4 Horner Probate Prac. & Estates § 2436. Individuals or corporate entities may act as trustees, either individually or jointly. The client should identify persons or entities who are capable of managing and investing assets, who have business and tax sense, and who can deal with beneficiary needs and demands.

If the trust is a living trust (a revocable trust created during the grantor's life), most frequently, the client will act as initial trustee while alive. Some clients, however, prefer to have someone else act as trustee *ab initio*, particularly if the trust is funded and investment management expertise is desired.

Successor trustees should also be identified to provide for the possibility that the initial trustee is unable or unwilling act, and to provide for continuity of management of the trust into the future. The spouse, adult children, business associates or close friends, or a corporate entity should be considered as potential successor trustees. Care should be taken, however, to ensure the trustee has qualities appropriate for the undertaking.

Co-trustees may be advantageous in situations where the grantor does not wish to give all of the power to one person or entity, or wishes to have a balance in the decision-making, or where the exercise of certain trustee powers by a trustee/beneficiary would have detrimental tax consequences.

3. The Beneficiaries. The beneficiaries are the persons or entities entitled to the benefits (income, use, or principal) of the trust property.

II. Importance of Trusts to an Integrated Plan

A. The Estate Plan as a Cohesive Unit.

Typically, a revocable, living trust is accompanied by a very simple "pour over" will, even if the client intends to transfer all of the assets into the revocable trust. Even if the client has as a major objective the avoidance of probate, a will is still a very vital part of the estate plan. In many situations, where the grantor has been very organized in transferring all assets to the trust, some amount of property (valued at more than the small estate affidavit value, currently \$100,000 – *See*, P.A. 93-877 amending IL ST CH 755 § 5/25-1 effective August 6, 2004) is overlooked, and probate is needed. In that event, if there is no will, an intestate probate procedure must be initiated, and probate may become very burdensome.

The provisions of the trust should complement the provisions of all of the client's other documents:

1. the tax clauses in the will and the trust must be coordinated to assure that one identified fiduciary has the duty to pay the taxes;
2. the dispositive provisions must be coordinated to ensure that gifts are made from the appropriate source and are not duplicated;

3. if the client has more than one trust (*e.g.*, a revocable and an irrevocable trust), or if both spouses have trusts, it can be advantageous to ensure that the dispositive provisions are the same (only if both spouses have the same dispositive intent, of course), to allow for merger and more efficient administration after death;

4. the “whole” plan must be designed to ensure that all of the grantor’s assets are distributed. This requires careful planning as to how gifts are made subject to certain contingencies (*i.e.*, survival to a specified age, remarriage, death with or without descendants, etc.). Every contingency must be considered in the planning. Obviously, one cannot assume that the oldest family member will be the first to die.

An important rule of drafting to keep in mind: The terms of the will cannot dictate the actions of the trustee, nor can the terms of the trust dictate the actions of the executor.

B. Integration with State and Federal Law.

The document may be both integrated and cohesive, and yet if it does not comply with the law, it may be worthless, or at least the source of extended litigation. The drafting attorney must become familiar with applicable state and federal tax law, as well as state property, trust and principal and income law, to assure that the document will work.

Chapter 11 of the Internal Revenue Code includes most of the federal estate tax provisions; Chapter 13 includes the Generation Skipping Transfer Tax provisions. Illinois has an estate tax at death which is found at 35 ILCS 405/1 et seq. The new Illinois estate tax is no longer a “pick up” tax. Drafting which does not take the state death tax issue and the foregoing statutes into account may result in onerous taxes and litigation.

The Illinois Trusts and Trustees Act (760 ILCS 5/1 et seq.) and the Illinois Principal and Income Act (760 ILCS 15/1 et seq.) are applicable to all Illinois trusts. The attorney should be familiar with the provisions of both acts in that they impact heavily on many drafting issues.

III. Planning Fundamentals

A. Asset Management.

Assets can be transferred to a living trust during the grantor’s lifetime and such assets may be used for the benefit of the grantor and others while the grantor is alive. Bank or stock accounts, individual stock interests, real estate and other assets may (and, it is recommended, should) be transferred to the trust. Transfers to a revocable trust are not completed gifts for gift tax purposes.

If the trust is funded, the grantor may deal with assets in the living trust just as if they continued to be owned in the grantor's own name. The assets can be transferred or sold; income earned is reported on the grantor's personal income tax return; and there is no additional filing or reporting required, assuming that the grantor is also a trustee. (If the grantor is not a trustee, the general rule is that a federal identification number must be obtained for the Trust.) The assets used to fund the revocable trust are included in the grantor's estate for Federal estate tax purposes. Sections 2036(a)(1) and 2038(a)(1).

Some grantors will fund their trusts during life, and appoint a corporate fiduciary to act for investment and management purposes. Grantors choose this option if they do not want to, or are unable to oversee the management of the trust, or if they desire to preview the performance of that fiduciary.

B. Planning for the Grantor's Incapacity.

Lifetime funding may be particularly advantageous in the event the grantor becomes incapacitated. The named co- or successor trustees can manage the assets in the trust for the grantor's benefit, while the grantor is unable to do so, and guardianship proceedings can be avoided. Using the funded trust provides more control and direction than relying upon a power of attorney for property. Some commentators believe that planning for incapacity is not necessary for young clients: but anyone who believes that incapacity is not a possibility is rather unrealistic, and also, obviously would not consider a living trust advantageous for this purpose. See Appendix A, Revocable Trust, page 1-9, Article 2, §2.2, 2.3 and 2.4.¹

C. Avoiding Probate.

Many commentators address the issue of "avoiding probate", and use of a living trust is one of the methods most frequently advocated. To the degree assets are transferred to a living trust during the grantor's lifetime, expense and delay of asset transfer are minimized at death. Those assets may be administered and distributed by the trustee, and will not have to go through probate (or ancillary probate) proceedings at death. On the other hand, probate is no longer a terribly burdensome process and has some advantages, depending upon the estate. A probate proceeding may be advantageous in that it cuts off creditors' claims after six months. See, 755 ILCS 5/18-12 and 755 ILCS 5/18-3. Previously there was a greater tax advantage in having the probate estate as a separate taxpayer, but now, due to the compressed trust and estate income tax rate structure, that advantage is minimal.

¹ All references to the Revocable Trust refer to *Estate Planning Forms and Commentary, Introduction to Model Form Book and Annotation of Model Form* © 2002., by Susan T. Bart, Timothy G. Carroll, Robert E. Hamilton, Louis S. Harrison and Donna E. Morgan.

D. Control after Death.

One of the greatest advantages of a trust is that it allows the client to control the disposition of assets “beyond the grave”. For grantors who do not wish to have their children receive a windfall at an early age, distributions of principal may be made over a period of years; for grantors who have spendthrift or disabled family members, principal need not ever be distributed. In a second marriage situation, a trust can be designed to benefit the current spouse, and to ensure that assets accumulated during a prior marriage eventually benefit children of that prior marriage.

E. Tax Planning.

On a very practical level, even with the 2001 tax law which phases out the estate tax by 2010 (for one year only), a trust is needed for tax planning purposes in every estate which will have a value at death in excess of the “exclusion amount”, currently \$1,500,000. A married couple can utilize the “unlimited marital deduction” together with the exclusion amount to shelter \$3,000,000 from federal estate taxes if appropriate tax planning trusts are in place. (In 2009, the federal applicable exclusion amount differs from the Illinois applicable amount. This divergence is discussed in Section IV.B.4 below. *See also* Appendix B.)

F. Privacy.

Additional advantages which may or may not be of importance, include privacy issues and the decreased likelihood of legal challenge. A will, including a will with a testamentary trust must be filed within 30 days of the testator’s death with the county probate clerk, and is open to public inspection, whereas a trust is not so filed. 755 ILCS 5/6-1. If there are heirs or beneficiaries who are likely to challenge the disposition of assets at death, a trust is usually more difficult to attack and defeat in litigation.

G. Flexibility.

Possibly the most important attribute of trusts, and in particular, revocable trusts (at least in the mind of this writer), is the great flexibility in planning that is possible. The experienced estate planner has in a revocable trust a vehicle which can be fashioned to meet all kinds of family needs - second marriages, non-U.S. citizen spouses, disabled family members, estranged children, children with bad habits, spendthrifts or substance abusers, and even family pets. *See* 760 ILCS 5/15.2 (“A trust for the care of one or more designated domestic or pet animals is valid.” Effective 1/1/05). Further, all kinds of special assets can be planned for specifically – real and personal property, closely held companies, partnerships, farms, collections, and insurance.

H. Planning for a Beneficiary's Disability.

If there is a disabled child (or other family member), and the client wants to ensure financial or personal support services for the child, a revocable trust provides an appropriate vehicle. Likely it would be very inappropriate for the child to receive assets outright. Further, an outright bequest to the child may disqualify the child from the benefit of State or Federal entitlement programs which may be available.

Distributing the child's share to another, *e.g.*, a sibling, to be managed for the child's benefit, will establish a moral obligation in that sibling, but will not be legally enforceable. If assets are available, funding a trust for the child's benefit is clearly the best option.

The Trusts and Trustees Act specifically provides trusts for disabled individuals. *See* 760 ILCS 5/15.1. A trust may provide discretionary benefits for the disabled person, and the trust is not liable to pay or reimburse the State or any public agency for services to the disabled person, assuming the disabled person did not create and cannot control the trust. (Previously, government agencies regularly attempted to reach the assets of such trusts.) The relevant federal Medicaid statute can be found at 42 U.S.C. 1396.

I. Managing other Problems.

If the client has concerns over a child's drug dependency or other behavioral problems, distribution provisions in the trust may be contingent; and by requiring that the child meet specified conditions. For example, before receiving any distribution, the child may be required to deliver satisfactory evidence of freedom from drug and alcohol dependency; the requirements for such evidence can be fully described in the document. In the event that the child does not deliver such evidence to the trustees, distributions can be eliminated entirely, or made in the sole discretion of the trustee for the child's needs.

Similarly, if a child is a spendthrift, distributions can be made only for very specific purposes, can be extended for long periods of time, or can be subject to conditions. For example, the child may receive distributions only upon presentation of evidence of gainful employment; the trust may be allowed to pay out only amounts dependent upon proof (*e.g.*, a W-2 form) of how much the child earned during the previous year.

IV. Drafting Fundamentals

A. Basic Principles.

As in drafting any legal document, the trust should read well. The attorney should be sure that all of the alternatives found within a form document (*i.e.*, he/she; and bracketed material, are edited appropriately.) In spite of the abundance of legal and tax jargon, the document must make sense. Many estate planning attorneys today use a format where only the most necessary provisions are up front (usually to describe lifetime and required

at death administration, *i.e.*, payment of taxes), followed by the dispositive provisions (presented in a readable manner, and leave all of the administrative provisions at the end, or in an Appendix incorporated by reference.

Although much of what is included in the administrative section is also included in the Illinois Trusts and Trustees Act (*e.g.*, trustee powers, resignation, facility of payment etc.), it is recommended that those provisions be spelled out in the document itself, rather than relying upon or incorporating the statute. Trusts frequently continue for many years, and if the statutes change in the interim, extensive research may be required to determine which provisions apply. Also, if an individual trustee is acting, it will be helpful for that person to have all of the relevant provisions in the document itself.

If the attorney decides to cut and paste, using provisions from a variety of forms, extra scrutiny is required to assure there is no duplication, that cross-references are correct, and that the document is consistent (*i.e.*, the terminology does not shift from first to third person, from grantor to settlor, or from wife or husband to spouse). Inapplicable references should be deleted (*i.e.*, if there is no possibility of a corporate trustee or a co-trustee, delete those references; if there is no spouse, delete all references to the spouse and to the marital trust).

B. Drafting Checklist: Important Provisions.

1. Right to Amend and Revoke. A major advantage of a living trust is its ability to be easily changed to meet the changing asset, tax and family situation of the grantor. In Illinois, a trust is presumed to be irrevocable unless otherwise specified. *See Pernod v. American National Bank*, 8 Ill. 2d 16, 132 N.E.2d 540 (1956). As a result, it is extraordinarily important to identify that the trust is revocable, and to describe the method for amendment. Appendix A, Revocable Trust, Page 1-9, Article 2.1.

Typically a trust must be amended by a signed writing delivered to the trustee during the grantor's lifetime; it may be that the amendment, in addition, requires an acknowledgment. Whatever method of amendment is specified, it is controlling, and any amendment or revocation must comply with the terms of the trust.

2. Lifetime Provisions. The essence of a revocable living trust is that it provides for the grantor, and other identified beneficiaries, if appropriate, during the grantor's lifetime. The addition of lifetime provisions to every revocable trust is recommended, in that the provisions require very little additional language, and can provide for the management of assets and aide to the grantor in the event of

disability.² Appendix A, Revocable Trust, page 1-9, Article 2. If lifetime provisions are not included, and the grantor becomes disabled, a court appointed guardian may be needed to manage the grantor's assets.

A revocable trust should always include a definition of "incapacity" which would apply to the grantor/initial trustee. If the definition is not included, the interested parties would have to go to court to have the determination of incapacity made. Appendix A, Revocable Trust, page 1-9, Article 2.3.

3. Payments Clause - Taxes, Debts, Expenses. It is of great importance to make sure that the payment clauses of the will and trust are coordinated, and that the duty to make the payments is specifically assigned to either the trustee or the executor. If the revocable trust will be funded, it may be appropriate to have the trustee pay the taxes, or to supplement payment if the probate estate is exhausted. Appendix A, Revocable Trust, page 1-38, Article 14.

4. Funding Clause - Marital Deduction/Unified Credit. If the client has some interest in minimizing federal estate tax, the funding clause is crucial, at least until 2010. Appendix A, Revocable Trust, page 1-11, Article 3 and page 1-42, Article 15.11. The funding clause provides the basis for utilizing the \$1,500,000 exclusion amount (in 2004 and 2005) and the unlimited marital deduction, with the result that there will be no federal estate tax at the death of the first spouse, and at the death of the second spouse, the full exemption amount for married couples, currently \$3,000,000 will have been protected from federal estate tax. If the clauses are not drafted correctly, the tax savings may be lost. (See Appendix B for increases in the exclusion amount and phase out of the estate tax.)

Additionally, the dispositive provisions must be drafted in a manner that the tax attributes of the trust maintain the eligibility for the tax benefits. For example, the marital trust must meet the requirements of IRC § 2056 as either a net income/general power of appointment marital trust or a Q-tip marital trust. Appendix A, Revocable Trust, page 1-14, Article 4.

The marital deduction will be lost in a general power of appointment marital trust if the spouse is not the sole beneficiary of the income and principal during life, or if the spouse is not entitled to all of the income. The trustee may make payments to other persons with the spouse's consent. A lifetime special power of appointment is typically used for this purpose.

² The grantor should also execute a durable power of attorney for property, with specific powers added so that the agent can fund the trust, in the event the grantor has not funded the trust prior to the disability.

In a Q-tip trust, the tax advantage is lost if:

- a. the spouse is given a lifetime power of appointment, to descendants or to others; IRC § 2056(b)(7)(B)(ii)(II);
- b. accrued and undistributed income is paid to any other beneficiary; IRC § 2056(b)(7)(B)(ii)(I). *But see Estate of Howard v. Commissioner*, 910 F.2d 633 (1990), Rev'g. 91 T.C. 329, which refutes this requirement. This issue is still unsettled, and it is recommended that the income of a Q-tip marital trust only be available to the spouse, with either a general testamentary power of appointment over the income or payment to the spouse's estate.

It is important to note that the applicable exclusion amount will be \$3,500,000 for federal estate tax purposes beginning January 1, 2009 (and the estate tax is repealed, for one year only in 2010). However, the Illinois estate tax caps the Illinois exclusion amount at \$2,000,000. This is because of the way the Illinois legislature has chosen to define the state death tax credit. 35 ILCS 405/2(b). Accordingly, a document that provides for a family trust equal to the federal applicable exclusion would have to pay Illinois estate tax in the year 2009. *See Appendix B*. Again, in that year only, the federal applicable exclusion amount is \$3,500,000 and the Illinois applicable exclusion amount is only \$2,000,000.

But fully funding the family trust may be advantageous to a married couple. By funding the family trust with \$3,500,000 in 2009, rather than \$2,000,000 (the amount sheltered under Illinois law), an additional \$1,500,000 will not be subject to tax at either spouse's death. The Illinois tax on the additional \$1,500,000 is \$229,200. But the federal estate tax on that amount is \$675,000. And considering the appreciation on that amount (\$1,500,000), the federal estate tax on that amount at the second death would likely be even higher.

Other planners may suggest using a formula that will give to the family trust only the amount of the state death tax exemption. Thus, there would be no tax on the death of the first spouse, and part of the first spouse's federal exemption would be left unused. Importantly though, the surviving spouse could use a disclaimer to adjust the amount passing to the family trust to allow for flexibility if it was then decided that some tax to Illinois should be paid.

In the analysis as to how much to subject to Illinois tax at the first spouse's death, several questions might be addressed. These include: the age and health of the surviving spouse, the possibility of consumption by the surviving spouse and the willingness of the surviving spouse to pay some estate tax at the first spouse's death. *See "The Illinois Estate Tax – One Year Later," Jason S. Ornduff, CBA Record, September 2004, p. 30.*

5. Complete Distribution. The objective in most situations is to assure that all of the client's property is eventually distributed by the trust. The attorney must be careful to assure there are no gaps in the distribution scheme. Gaps can occur in a variety of ways. Some form of ultimate distribution language should be included to provide for the possibility that no beneficiaries survive. Appendix A, Revocable Trust, page 1-11, Article 3.3(b) and 3.4; and page 1-40, Article 15.1.

6. Trustees. Although identifying trustees and successor trustees sounds like a simple drafting assignment, it can be fraught with difficulties.

a. Initial and successors. It is important to designate successor trustees for all eventualities. Trustees die, become incapacitated, move away, or simply may be unwilling to act. Naming a corporate trustee may avoid the possible frailties of an individual trustee, but is not a guarantee. A corporate trustee may be unwilling to act if the trust contains few, or difficult (*e.g.*, environmentally unattractive) assets. As a result, a succession of trustees should be named, and language should be included to provide for a vacancy. Although drafting such a succession may sound simple, it can be quite complex, and the attorney should consider every contingency when drafting the trustee succession language.

b. Resignation and removal. The Illinois Trusts and Trustees Act provides for trustee resignation and for appointment of a successor in the event of a vacancy. *See* 760 ILCS 5/12,13. The Act does not provide for removal of a trustee, and under Illinois law, if there is no provision in the document, a trustee may be removed only by a court proceeding, and then only if there are grounds for such removal. In some cases, corporate trustees may be very resistant to resign because of their economic disincentive to do so.

The trust document should always include provisions for resignation and appointment of successor trustees. Appendix A, Revocable Trust, page 1-22, Article 10.2 and Article 10.3. If the trust includes provisions for discretionary distributions, there may be adverse income or estate tax consequences if a beneficiary can be self-appointed or can appoint other persons as trustee.

Inclusion of provisions for removal becomes a trickier question, and will depend upon the grantor's objectives and the family situation. If the grantor feels strongly that the appointed trustee should act, then removal provisions may be inappropriate. If for example, the spouse is the trustee of a spray trust for the benefit of the spouse and descendants, and the document allows a majority of the adult beneficiaries to remove the

trustee, the adult descendants might remove the spouse. This is likely not the desired result.

Further, the removal power may have adverse tax implications, and so, must be carefully drafted. Rev. Rul. 79-353 ruled that a trust is includable in the grantor's estate if the grantor has the right to remove a corporate trustee and name another corporate trustee. The impact of this ruling has been lessened by *Estate of Wall v. Commissioner*, 101 T.C. No. 300 (1993), wherein the Tax Court ruled such a removal power would not result in tax inclusion. And Rev. Rul. 79-353 was revoked by Rev. Rul. 95-58. In the latter ruling, the Service opined that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of Section 672(c)), the trust would not be included in the grantor's estate. This area remains a bit unsettled, and the removal power should be carefully considered. To counter the potential tax problem, some attorneys name an independent trustee remover in the document.

c. Co-trustee governance. Whenever it is possible that more than one trustee will be acting, provisions should be included which will provide for how they act together, particularly:

- i. Whether one may delegate to the other (or others) any of the trustee duties or powers;
- ii. how many or which trustees can make a decision if there is disagreement (majority, individual/corporate/oldest child etc.).
Appendix A, Revocable Trust, page 1-24, Article 11.1.

d. Interested trustee provisions. If a trustee is also a beneficiary, and if the trustee is deemed to have a general power of appointment over the trust, the trust corpus may be included in the trustee's estate at death. If ascertainable standards are used for discretionary principal distributions, there should be no problem.

Ascertainable standards include standards such as health, maintenance, support, illness etc. See IRC § 20.2041-1(c)(2); Appendix A, Revocable Trust, page 1-38, Article 13.19(c).

However, even with an ascertainable standard, if the trust could use trust assets to discharge a trustee's legal obligation of support, the trustee is

deemed to have a general power of appointment, and the assets will be included in the trustee's estate. *See* IRC § 20.2041-1(c)(1).

If a trustee named would potentially be managing the trust for that trustee's dependents, "interested trustee" language should be included to assure that such trustee cannot act to discharge a legal obligation of support. Appendix A, Revocable Trust, page 1-38, Article 13.19(b). If there is only one trustee acting, there will be a problem if this situation occurs, in that no one will be able to make such distributions. This possibility should be considered when determining who will be named as trustees.

e. Other advisers. In many instances, the grantor may wish to name another individual as adviser for investments or special assets. Appendix A, Revocable Trust, page 1-25, Article 11.6.

7. Merger. When possible, it may be advantageous to assure that trusts for the same beneficiaries have parallel provisions under separate trusts, so that at some time in the future, the trust may be combined for purposes of efficiency of administration. Appendix A, Revocable Trust, page 1-37, Article 13.15.

8. Small Trust Termination. It is strongly recommended that the trustee be given the power to terminate a small trust. Even with a large estate, once trusts are divided and expended for beneficiaries, and held into the future, the trusts may become small. Small trusts can become very expensive to administer, even if the trustee is an individual, because there are costs related to record keeping, tax reporting and investing the assets. Beneficiaries become very unhappy if the costs of maintaining the trust outrun the income generated by the trust. Although sometimes termination amounts are specified by a dollar figure, greater flexibility is recommended. Appendix A, Revocable Trust, page 1-36, Article 13.11.

9. Trustee Powers. The Trusts and Trustees Act includes extensive statutory powers for Illinois trustees. *See* 760 ILCS 5/1 et seq. Although some attorneys choose to incorporate the statutory powers by reference, a better practice is to delineate those powers in the trust itself. Statutes change, and individual trustees may lack familiarity with the statutes. Further, all of the desired powers are not necessarily included in the statute. If there are or may be special assets or assets with potential environmental problems, the trustee powers should be expanded to allow the trustee to deal with those situations.

10. Provisions for Accrued Income.

- a. Addition to principal. If the trust provides for discretionary distributions of income, there should be language requiring that undistributed income be added to principal.
- b. Addition to marital estate. As noted above for a marital trust, to qualify for the marital deduction, the spouse must receive all of the income. Therefore, in the marital trust, all of the income must be paid to the spouse's estate at death, or in the alternative, the spouse must have a general power of appointment over the income. *See Appendix A, Revocable Trust*, page 1-34, Article 13.1(b).
- c. Payment to next beneficiary. In trusts other than the marital trust, the trust should provide that any undistributed income be paid to the next taker, to assure that all of the trust is distributed, not just the principal.

11. Facility of Payment. These provisions allow the trustee to apply payments for the benefit of the person named, rather than making the payments directly. *See 760 ILCS 5/4.20 as amended by P.A. 93-695, Approved: July 9, 2004; Appendix A, Revocable Trust*, page 1-36, Article 13.13.

12. Spendthrift Clause. Spendthrift language is included to bar a *beneficiary's* creditors (not the grantor's creditors) from attaching the trust, and such provisions are valid under Illinois law. A spendthrift clause can bar alimony claims, but not claims for child support. *See Oppenheim v. Scully*, 86 N.E.2d 431 (1949) and Appendix A, Revocable Trust, page 1-36, Article 13.14. Importantly, a spendthrift trust will not be considered to be part of the bankruptcy estate under federal law. 11 U.S.C. 541(c)(2).

13. Perpetuities Savings Clause. Perpetuities savings language is included to ensure compliance with the default Illinois rule that requires that interests vest within lives in being plus 21 years after the creation of the interest. *See 765 ILCS 305/1 et seq.; Appendix A, Revocable Trust*, page 1-36, Article 13.12. It is helpful to use beneficiaries rather than descendants as measuring lives, to broaden the class in the event there are non-descendants included as beneficiaries.

In 1997 Illinois enacted a law which provides that the rule against perpetuities will not apply to "qualified perpetual trusts" created or amended after January 1, 1998 or to qualified perpetual trusts created by exercise of a power of appointment granted under such post-1997 documents. Grantors may "opt out" of the rule against perpetuities. *See 765 ILCS 305/4(a)(8)*.

If both husband and wife have trusts, it is recommended that the perpetuities language be structured in the same way or hinge on the same event, *i.e.*,

“beneficiaries living at the date of death of the last to die of my spouse and me”. Making the perpetuities savings language parallel will allow the two trusts to be merged after the survivor’s death, if in fact the provisions are otherwise substantially the same.

14. Applicable Law. For an Illinois grantor, typically the trust will state that Illinois law applies to the validity, construction and administration of the trust. A specific statement of applicable law is helpful, and will eliminate questions of conflict of law in the event of relocation of any party or of the assets. Appendix A, Revocable Trust, page 1-37, Article 13.17.

Even with an out-of-state grantor, it is extremely helpful to the Illinois trustee if Illinois law is applied to the administration of the trust. If another state’s law is to apply, it will be less efficient and more expensive for the trustee who has to research the law of that state. A recommended alternative would be to include an applicable law provision which shifts in the event that the trustee or the assets are located in another jurisdiction.

15. Execution. A revocable trust does not have to be executed with the formalities required for a will. However, it may be useful to have witnesses and acknowledgment if the trust will hold real estate, if there is a possibility it will be administered in another state, or if there is a chance that the grantor’s capacity might be challenged.

A trust may be executed in duplicate, unlike a will. Also, if the client is also using a pour-over will, the trust should be executed first. The Illinois Probate Act provides that testamentary additions may be made to a trust if the trust is in existence when the will is executed. *See 755 ILCS 5/4-4.*

C. General Considerations.

In addition to paying great attention to all the particulars, the general requirements and the array of applicable law, the drafting attorney needs to step back and take an overview, in an attempt not to “overdraft” (or “underdraft”) for the client.

For an example of overdrafting: In spite of the great value obtained by utilizing the marital deduction/exclusion plan, it makes no sense to draft the marital/family trust combination if the clients have less than \$1,500,000 of value in their combined estates, unless the likelihood is great that the values will change in the near future. At the opposite extreme, not utilizing these tax planning devices for an estate in excess of \$1,500,000 is an example of potentially serious underdrafting.

Another example of overdrafting is found in a plan which sets up multiple trusts, none of which is very large. In spite of a client’s possible desire to have funds managed separately

for descendants, if the funds are not very large, it can be inefficient and expensive to do so.

V. Types of Trusts Compared

A. Revocable Trusts [Intervivos, living, loving, insurance, and declarations of trust]. A revocable or living trust is a “stand-alone” document, usually accompanying a pour-over will, which can be activated during the grantor’s lifetime. A revocable trust is distinguished from an irrevocable trust in that revocable or living trusts can be amended, and revoked with ease whenever the client’s objectives, family or asset situation changes in a way making modification to the trust appropriate.

Other forms of revocable trusts include:

1. Joint Trusts. Joint Trusts are a form of revocable trust where husband and wife are both grantors. Although they are commonly and appropriately used in community property states, they are less common, and less appropriate in separate property states such as Illinois. Joint trusts can be technically very difficult to draft, in that there can be substantial (and to many attorneys, unexpected) income tax ramifications for each grantor, and because drafting for utilization of the exclusion amount for each of the grantors can be very difficult. Joint trusts would be recommended only in certain, very specific situations, most typically small estates.

2. Qualified Domestic Trusts (“QDOTs”). The 1988 Tax Act (TAMRA) changed the marital deduction rules for non-U.S. citizen spouses, taking away the unlimited marital deduction. As a result, it is very important to determine if a spouse is a U.S. citizen, and if not, to make sure that the trust which is drafted for that spouse’s benefit meets the requirements set forth in Section 2056A.

B. Testamentary Trusts [Trusts under Will].³ A testamentary trust is a document which is usually identified as a will, serves all of the purposes and requires all of the formalities of a will, and incorporates within the same document, a trust. All of the decedent’s assets which are included in the probate estate are typically distributed to the trustee named within the will, at the testator’s death, and managed into the future in accordance with the terms of the trust under will. Just as a will can be amended from time to time, a testamentary trust can be changed as well.

³ As the emphasis in this presentation is upon the Revocable Trust, a form of testamentary trust has not been included. Most estate planning form books, however, do include forms for a trust under will.

C. Irrevocable Trusts.⁴ Irrevocable trusts come in many different formats which are not synonymous one with another. Not surprisingly, one common element is that such trusts, for most purposes, cannot be changed.

Irrevocable trusts are used to accomplish a variety of purposes, the main purposes being accumulation of value for descendants, tax planning and savings, liquidity at death (for estates with highly valued but illiquid assets, *e.g.*, closely held stock) or to provide a bonanza for the beneficiaries.

Frequently irrevocable trusts are funded by utilizing annual exclusion gifts to the trust, structured to assure such gifts will qualify as present interests, or by transferring insurance policies to the trust, also by a means of an excluded transfer which is tax-driven. If the trust is properly drafted, assets transferred to an irrevocable trust should not be included in the grantor's gross estate for Federal estate tax purposes. Valuation of assets transferred may be dependent upon the Internal Revenue Service's tables, *e.g.*, a QPRT or CRAT.

These trusts must be very carefully drafted to accomplish the intended tax savings. The numerous requirements of the Internal Revenue Code and its regulations must be adhered to strictly. There have in the past few years been occasional attempts to curtail the use of irrevocable trusts, in particular those which use a *Crummey*⁵ format and qualified personal residence trusts. None of these attempts have been successful so far except when the planning appears egregious. *See for example Heyen vs. United States*, 945 F.2d 359 (10th Cir. 1991) (Annual exclusion gifts disallowed where gifts were made to intermediaries who immediately made gifts to the original donor's descendants.)

1. Minors' or children's trusts. Frequently persons who make gifts to descendants using the annual exclusion amount prefer to do so by making the gift to a trust. *Crummey* power trusts "Section 2503" trusts, are the most typical formats used. Although legislation to eliminate the *Crummey* power has been proposed from time to time, currently such gifts can be made to a trust if the gift can be characterized as a present interest, to meet the requirements of Section 2503(b). This requires that the beneficiary have a right of withdrawal over the value contributed to the trust. Alternatively, a Section 2503(c) trust does not require a withdrawal right, but rather, the beneficiary must have the opportunity to withdraw the trust assets at age 21.

⁴ A form of irrevocable trust has not been included in the Appendix, based on the scope of this presentation. For a useful form, see Estate Planning Forms and Commentary, Supra Note 1.

⁵ *See Crummey v. Commissioner*, 397 F.2d 82 (1968)

2. Charitable Trusts. For those clients who have charitable intentions, tax savings may be accomplished through various types of charitable gifts including charitable lead, remainder and annuity trusts. The Internal Revenue Service has published Rulings which include sample provisions, and Revenue Procedures which provide complete forms for drafting charitable trusts, and it is strongly recommended that the elements of those forms be carefully incorporated by the drafting attorney.⁶

3. Irrevocable Life Insurance Trusts (“ILITs”). Perhaps the most common form of irrevocable trust, many clients choose to give their annual exclusion gift amounts to a trust, so that the trustee can pay premiums on a life insurance policy. Frequently these trusts use a *Crummey* withdrawal format; wealthy clients often choose to have the trustee pay a large premium, either using their exemption amount or even paying the gift tax.

4. Charitable Remainder Unitrusts (“CRUTs”). A CRUT provides the grantor with a current income tax deduction for the present value of the gift which will eventually be made to charity. The lifetime non-charitable beneficiary receives an income equal to a fixed percentage of the trust assets, re-valued each year. At the end of the trust term (the income beneficiary’s life or a term of years not to exceed 20), the balance of the trust is paid to the charity or charities. Variations on the CRUT theme include a “NIMCRUT” (net income makeup trust) and a Flip Crut (A "flip" trust allows a net income unitrust to flip or change into a straight or fixed percentage unitrust once a triggering event occurs, such as the sale of assets which may be illiquid or hard-to-market e.g., real estate or closely held stock).

5. Charitable Remainder Annuity Trusts (“CRATs”). A CRAT is similar to the CRUT, but pays out an income stream to a non-charitable beneficiary based upon the initial value of the trust assets; whereas additional assets can be added to a CRUT, that is not so with a CRAT. *See* Section 664

6. Qualified Personal Residence Trusts (“QPRTs”). A QPRT is an irrevocable trust whereby the grantor can transfer up to two personal residences to a trust for a term of years at a reduced gift tax cost determined, in part, by the Service’s actuarial tables. *See* Section 2702.

⁶ *See e.g.*, Rev. Rul. 72-395 as further modified, and Rev. Proc. 90-31.

Appendix B

Comparison of Federal and Illinois Applicable Exclusion Amounts for Estate Tax Purposes

	Federal Applicable Exclusion Amount	Illinois Applicable Exclusion Amount
2004	\$1,500,000	\$1,500,000
2005	\$1,500,000	\$1,500,000

2006	\$2,000,000	\$2,000,000
2007	\$2,000,000	\$2,000,000
2008	\$2,000,000	\$2,000,000
2009	\$3,500,000	\$2,000,000
2010	No Tax	No Tax
2011	\$1,000,000	\$1,000,000