Taxation - Income, Estate and Gift

Adding flexibility to irrevocable trusts can help address tax law uncertainty.

By David R. Toups, JD, MBA, CFA®, CFP®, CTFA

Attorneys across the country are rapidly drafting irrevocable trusts for a multitude of clients who are anxious to capture the increased estate and gift tax exclusion amounts provided in the Tax Cuts and Jobs Act (TCJA). As enacted, the TCJA sunsets on its own at the end of 2025; however, due to ever-shifting political winds, these increased exemptions may be terminated much sooner—possibly even in 2021 or 2022, depending on the ultimate results of the November 2020 election cycle.

In the event changes or modifications are needed to any hastily created trusts that miss or misstate some provision, judicial reformation may be costly and may not always achieve the full extent of the change needed, especially if a not-so-loved one decides to oppose it for some concession or advantage.

In addition, upon the sunset or earlier repeal of the TCJA, the ability to gift approximately $5 million to others without gift taxes will vanish, and if later taxed, the estate will bear (assuming no additional asset appreciation) a $2 million tax bill at the current federal estate tax rate.

Since attorneys' schedules are filling up in anticipation of eventual repeal, this article is provided to describe some helpful provisions that can be added to irrevocable trusts to provide greater flexibility in relation to anticipated changes in the law.

Trust protector provisions

The first of the suggested provisions that may assist grantors to achieve the irrevocable trust's purpose are trust protector provisions. Trust protector provisions create a non-fiduciary office or role for an independent third-party, preferably with legal and business acumen, that typically would require a judge in a court of law to perform. Just as parties to a contract may opt to subject the agreement to arbitration or mediation, in essence choosing their own dispute resolution mechanism, a trust protector may serve a similar role by determining if and how a trust may be amended or modified to achieve its stated purposes. The trust protector may act as a failsafe mechanism, providing an independent party to change the trust's situs or terms to address unexpected changes that inevitably come to pass after an irrevocable trust is executed and administered.

Decanting the trust

A second suggested provision is to grant either the trustee or trust

protector authority to follow any appropriate decanting statute to transfer assets from the existing trust into a newly formed successor trust. Such provisions may be exceedingly important as the trust ages. Anyone who has administered or been a beneficiary under a trust drafted before major tax law revisions existed will readily understand the importance of such a provision.

An irrevocable trust may easily exist for fifty years or longer while changes naturally occur in tax and trust laws, product developments in financial instruments and services, long-term economic cycle fluctuations, and sociopolitical environments.

As the trust ages, there eventually may come a point that administration under the trust's antiquated language becomes impossible or unbearable. By invoking such statutory decanting provisions, the trustee or trust protector could transfer the trust assets into an updated trust with language specifically addressing the unforeseen changes or events that could have adverse effects on the trust's taxation, assets, or beneficiaries.

Powers of appointment

Third, powers of appointment may permit trust beneficiaries to direct their trust assets during their life or at their death to charity, to anyone in general, or to a narrowly defined class of people. The power of appointment provides the beneficiaries the ability to direct the trust assets directly to beneficiaries outright or on certain conditions, or indirectly to them by directing assets into updated and legally current trusts for remaining loved ones, similar to the decanting provisions referenced above.

Even when the aging trust contains provisions that would retain the assets in trusts for the intended successor beneficiary, consideration should be given to utilize an available power of appointment to direct assets into an updated trust based upon current tax and trust laws and contemporary trust planning strategies.

Reciprocal trusts

Finally, for spouses contemplating using their current $11.58 million life-time gift tax exemption by creating irrevocable trusts for one another, a note of caution: Beware of the reciprocal trust doctrine. If the net result of the two nearly identical trusts created in close proximity to one another leaves the parties in the same or a substantially similar position as before the trusts were created, the trusts will be disregarded, and each spouse will be deemed a grantor of the other's trust—making the gifts pointless from an estate tax perspective.

Trust differentiating strategies do exist to counter such a characterization and attorneys familiar with this area of the law should utilize them.

Conclusion

Whether the TJCA sunsets in 2025 or is repealed earlier, it's time for clients to have a conversation with their trusted legal or tax advisors about existing estate planning opportunities and strategies that may vanish very soon.

David R. Toups, JD, MBA, CFA®, CFP®, CTFA, joined The Nautilus Group in 2016 after more than 14 years in the private practice of law focused in estate, trust, guardianship, and business planning and litigation. Prior to practicing law, he managed money professionally as an investment portfolio manager for several national corporate fiduciaries. He earned his BBA in marketing from Texas A&M; his MBA, with a finance emphasis, from Sam Houston State; and his JD, with honors, from South Texas College of Law. David is a former U.S. Marine Corps artillery and infantry officer.

As a result of the Tax Cuts and Jobs Act of 2017 (TCJA) the estate, gift and generation skipping transfer (GST) tax exemption amounts increased to approximately $11.18 million per person (approximately $22.36 million for a married couple). For asset transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40%. While the exemption amounts are indexed for inflation, current law provides for an automatic sunset of these increased exemption amounts after 2025. As a result, the exemption amounts available in 2026 and beyond could be reduced to a level provided under prior law ($5.49 million/single and $10.98 million/couple in 2017, indexed for inflation) absent further action by Congress. In addition, under different rates, rules and exemption amounts (if any), there may be state and local estate, inheritance or gift taxes that apply in your circumstances. This material includes a discussion of one or more tax related topics. This tax related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purposes of avoiding any IRS penalties that may be imposed upon the taxpayer. The Nautilus Group® is a service of New York Life Insurance Company. Nautilus, New York Life Insurance Company, its employees or agents are not in the business of providing tax, legal or accounting advice. Individuals should consult with their own tax, legal or accounting advisors before implementing any planning strategies. The cash value in a life insurance policy is accessed through withdrawals and policy loans, which accrue interest at the current rate. Loans and withdrawals will decrease the cash surrender value and death benefit.
SMRU 1880208 Exp 12/8/2022