THE FLEXIBLE IRREVOCABLE TRUST
FAR MORE POWERFUL THAN YOU MAY HAVE IMAGINED

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I wanted to write an article about "irrevocable" trusts because I have found that they are widely misunderstood, even by many attorneys, accountants, bankers, and other professionals. When I typed the search term "irrevocable trusts" into Google, the first two results were an Ask.com article entitled "What is an Irrevocable Trust, "and an Investopedia.com article entitled "Irrevocable Trust Definition." These were the definitions they provided respectively:

> An irrevocable trust is a legal arrangement that, once created, cannot be terminated or otherwise altered by the creator.
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> A trust that can 't be modified or terminated without the permission of the beneficiary.

Both of these definitions while not lacking in some truth, are wrong. The creator of a trust (called the "Settlor") can modify some irrevocable trusts and many irrevocable trusts cannot be modified even with the beneficiary's consent. All this misinformation has led many people to avoid their use and by doing so, pass up one of the most powerful tools to protect their hard earned assets available.

An irrevocable trust means simply that the Settlor (again the trust's creator), cannot ***revoke*** the trust (i.e., get rid of or due away with it) directly and by him or her self. That is basically, it. That may initially sound restrictive, but as you will see in a minute, the Settlor can retain significant control over the trust and the assets transferred to it. Before delving into that discussion, however, I am going to first explain exactly what makes a trust asset protected in the first place (and with respect to whom). To make this task a little easier, lets start with a basic example that we can refer back to:

> Assume Mike creates an irrevocable trust and names it the "Brady Family Irrevocable Trust." After signing the necessary paperwork to create the trust, Mike first transfers $1 million dollars in cash to the trust. He does this by setting up a bank account in the name of the Brady Family Irrevocable Trust and then depositing money into that account. Next, he transfers a rental property he owns to the trust. This is accomplished by signing a deed that transfers the real estate from his name to the name of the Trustee of the Brady Family Irrevocable Trust and then recording that deed in the public records. Finally, Mike wants to transfer an interest in a business he owns to the trust. The business is held in a limited liability company ("LLC") so he signs an "assignment" which legally transfers his "membership

interest" in the LLC (like stock in a corporation) to the Brady Family Irrevocable Trust.

Mike is married to Carol and they have six nutty kids, Greg, Marcia, Peter, Jan, Bobby, and Cindy. Mike loves and trusts his wife and wants to make sure that she and the kids are properly taken care of so he names all of them as "beneficiaries" of the Brady Family Irrevocable Trust. The term "beneficiaries" refers to the people to whom trust assets (e.g., money, property, etc.) can be distributed to or whose expenses can be paid from the trust's bank account.

Mike now has to choose someone to serve as a Trustee of the Brady Family Irrevocable Trust. The Trustee is the person who is responsible for (i) managing all the trust assets, (ii) making certain discretionary decisions about how much money to distribute to the beneficiaries and for what purposes, and (ii) generally carrying out the "terms" of the trust (the "instructions of the Settlor," if you will). For example, the Trustee of the Brady Family Irrevocable Trust will be able to manage the cash in the bank account, invest the cash in stocks, bonds, mutual funds, etc., use the cash to buy real estate or business interests, use the cash to start a business (like an LLC) which will be owned by the trust, manage the rental property (e.g., decide whom to rent to, the rental amounts, etc.), and sell the rental property (and how to invest the proceeds from that sale). The choice of who should be your trustee, then is an important one. And as the word **trust**ee implies, they need to be someone you trust. Mike could be the Trustee in certain circumstances depending on his goals and objectives, but I'm getting ahead of myself. I'll come back to the issue of who can be trustee in a minute.

What Makes a Trust Asset Protected?

Another misunderstood aspect of trusts is why they provide asset protection at all, whose creditors are thwarted by the trust (e.g., the Settlor's creditors, the creditors of the beneficiary, the creditors of the trustee), and under what circumstances trusts fail to provide an asset protection benefit. Knowing this will make understanding irrevocable trusts in general (and more advance techniques, like the Florida Asset Protection Trust ("FLAPT)[1] much easier).

There are two primary means by which a trust can offer asset protection to its *beneficiaries*. The first of these two is the inclusion in the Trust Agreement of something called a "spendthrift clause." The second is to give the Trustee discretion over whether or not to make distributions to the trust beneficiaries. Each of these is discussed below. Understand as you read the following discussion, that it relates to trusts that are created by someone for the benefit of another and not a trust created by someone of which they are also a beneficiary.

[1] Please see my article "You've Heard of the Delaware and Nevada Asset Protection Trust . . ., Introducing The FLORIDA Asset Protection Trust, Less Expensive, More Protective, No Out of State Trustee Required."

Spendthrift Protection.
A general concept in asset protection planning is that a creditor generally cannot take what a person does not have the right to give. That is the basic idea behind a "spendthrift clause." The "spendthrift clause" itself is simply a provision in a Trust Agreement that restricts a beneficiary's ability to transfer, sell, or otherwise give away any of their rights in a trust.

> Assume that Conrad establishes a trust for the benefit of his child, Betty. The trust provides that Betty will receive $50,000 each year for the rest of her life. The trust was not drafted to contain a spendthrift provision. Betty is free to give away or sell her rights under the trust as a beneficiary. Since Betty has this right, if Betty is ever sued and a judgement is obtained by the plaintiff, Betty's beneficial interest in the trust could be taken by the creditor which would give the creditor the right to receive the $50,000 per year.
>
> Now assume the exact same facts, however, this time Conrad makes sure that the trust does contain a spendthrift clause thereby forbidding Betty from selling, giving away, or otherwise transferring her rights under the trust. If she is sued by the same creditor, the creditor will not be able to take her interest in the trust which will make it significantly more difficult for the creditor to reach any assets of the trust or distributions therefrom. It is important to note, however, that once a distribution is made to Betty, it is fair game for a creditor to go after.

There are some limits to spendthrift protection, however. Florida Statutes Section 1736.0503, states that a spendthrift provision is generally *unenforceable* against (i) a beneficiary's child with respect to a claim for child support, (ii) a beneficiary's former spouse with respect to a claim for alimony, (iii) anyone (such as an attorney) who has provided services for the protection of a beneficiary's interest in the trust, and (iv) the government. If the trust is also a discretionary trust (see discussion below), these exception creditors may still be thwarted from reaching the trust assets.

Discretionary Distribution Provisions.
The next broad category of protective trusts are discretionary trusts. If the Trustee has discretion over whether or not to make distributions to a trust beneficiary, the creditors of that beneficiary cannot reach the trust assets while they reside in the trust. Florida Statutes Section 736.0504 reads as follows:

> "(1) <u>Whether or not a trust contains a spendthrift provision</u>, a creditor of a beneficiary <u>may not compel a distribution that is subject to the trustee's discretion</u>, even if:
>
> (a) The discretion is expressed in the form of a standard of distribution; or
>
> (b) The trustee has abused the discretion.

> (2) If the trustee's discretion to make distributions for the trustee's own benefit is limited by an ascertainable standard, a creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee."

So even if a beneficiary of a trust (whether spendthrift or discretionary) is the sole Trustee of their trust, the trust assets can be protected from their creditors, including, divorcing spouses. In establishing protective trusts, it is usually best to use discretionary spendthrift trusts. This belt and suspenders approach provides the best protection since the protections compliment each other.

Do Revocable Trusts Protect Assets? Answer: NO.
Revocable trusts like the kind commonly used in estate planning provide ZERO asset protection to the trust's Settlor (i.e., creator). Florida Statutes Section 736.0505(1)(a) states that "the property of a revocable trust is subject to the claims of the Settlor's creditors during the Settlor's lifetime to the extent the property would not otherwise be exempt by law if owned directly by the settlor." This means that the property held in a Revocable Trust has the same asset protection as if the trust were ignored and the trust assets were owned directly by the trust's creator. Put another way, a Revocable Trust does absolutely nothing to protect assets from the settlor's creditors. Note, however, that if Mike Brady established a revocable trust for estate planning purposes and he and his wife, Carol, were both Co-Trustees, if *Carol* were sued and her creditor obtained a judgement against Carol alone (i.e., not Mike), the assets in Mike's revocable trust would be protected. The fact that Carol is acting as a Trustee does not subject the trust assets to the claims of her creditors.

Do Irrevocable Trusts Protect Assets? Answer: Sometimes.
When discussing whether or not an irrevocable trust provides asset protection benefits, we first need to ask the question "WHO'S creditors are we talking about?"

Beneficiaries.
Going back to the Brady Family Irrevocable Trust example, if Carol or the other BENEFICIARIES (i.e., not Mike, the Settlor) were sued, then provided the trust is properly drafted to contain spendthrift and discretionary distribution provisions, it will provide excellent asset protection (i.e., the creditors of the beneficiaries cannot reach trust assets).

Trustees.
Just because a person is a Trustee of a trust does not subject the trust assets to the claims of their creditors. A Trustee is a fiduciary in charge of managing trust assets and carrying out the instructions contained in the trust *for the benefit of the beneficiaries*. A Trustee has *no property interest* in the trust assets by virtue of being a Trustee. If a Trustee decided they wanted to take property out a trust and spend it on themselves even though the Trustee was not a beneficiary, they would be breaking the law and the trust beneficiaries could sue the Trustee (and win). Therefore, since the Trustee has no right to trust assets, their creditors have nothing to reach.

The Settlor.
But what about the Settlor of a trust. Going back to the Brady Family Irrevocable Trust, could Mike's creditors reach the trust assets? Assuming that Mike did not transfer assets to the trust in anticipation of being sued (i.e., he was specifically transferring assets to the trust to "hinder, delay, and defraud" his creditors), then Mike is in a similar position to the Trustee. He has no property interest in the trust since he is not a beneficiary. And, for that reason, Mike's creditors have nothing to take. Of course, if Mike did know that someone was about to sued him and then made the asset transfers, those transfers could be "unwound" or set aside under the fraudulent transfer laws. But this has nothing to do with trust. If Mike made a fraudulent transfer to another person (his brother, for example), the transfer could likewise be set aside.

The Settlor / Beneficiary.
But what if Mike was both the Settlor and a trust beneficiary. This results in the trust being classified as a "Self-Settled Trust" or a trust a person creates for them selves. Self-Settled Trusts, unfortunately, are subject to what I'll refer to as the "Maximum Permissible Distribution Rule" contained in Florida Statutes Section 736.0505(1)(b), which states:

> (b) With respect to an <u>irrevocable trust</u>, a creditor or assignee of the settlor may reach <u>the maximum amount that can be distributed to or for the settlor's benefit</u>. If a trust has more than one settlor, the amount the creditor or assignee of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution."

Assume for a minute that Mike was a named beneficiary and the Trustee had discretion to give Mike as much or a little of the trust assets to Mike as the Trustee saw fit. If that were the case, then ONE HUNDRED PERCENT (100%) of the trust assets could be taken by Mike's creditors even if the trust contained spendthrift and discretionary distribution provisions. Also note that it does not matter what the Trustee *actually* does, just what he has the *authority* to do. If the Trustee desperately wanted to help you and absolutely refused to make a distribution, a court could still override them and give the trust assets to the creditor.

Now lets put a slight twist on this example. Assume that Mike is a named beneficiary under the trust but the trust provides that the Trustee can only distribute up to $50,000 a year to Mike. Then if Mike were ever sued and ended up with a judgement against him, the creditor could only reach $50,000 a year and the rest of the trust assets would be safe. This "Maximum Permissible Distribution Rule" has been abolished in certain offshore countries and also in many states in the U.S., including, Delaware, Nevada, Alaska, and South Dakota, to name a few. There are at least three problems with using these foreign and domestic asset protection trusts, however.

> 1. <u>Laws Are Yet Untested</u>. First, despite the fact that I think these laws have an excellent chance of being upheld if challenged, the fact is that no such challenge has yet to be made with respect to DAPTs (i.e., "Domestic Asset Protection Trusts like those established under Delaware or Nevada law). Therefore, it is still uncertain as to how well they will work.

There have been challenges made to FAPTs (i.e., "Foreign Asset Protection Trusts like those established under the laws of the Cook Islands, for example) and they generally work well, however, they do not do a very good job of protecting assets located in the United States, and, more importantly, there is a chance a judge could throw you in jail for civil contempt of court to "test whether you have the power to bring assets back." This is not something to be taken lightly. A man by the name of Steven J. Laurence spent six years in jail for civil contempt of court after establishing a FAPT.

2. Cost. The cost to set up a DAPT typically averages around $15,000 and the cost to set up a FAPT runs around $25,000. In addition, since you have to name a Trustee located in the particular jurisdiction for the trust to be effective, the Trustee will typically charge between $4,000 and $5,000 per year (on the low end). If they actively manage trust assets, these costs can be significantly more.

3. Control. As stated above, in order for a DAPT or FAPT to be effective, you must appoint a Trustee located in the particular asset protection jurisdiction. This typically means that the person who creates the trust loses some control over the trust assets. There are ways to allow the Settlor to continue to manage assets held in a DAPT or FAPT, but a full discussion of these techniques is beyond the scope of this memo.[2]

I do not want you to leave this section with the impression that DAPTs or FAPTs are poor asset protection tools. They are not. Each one can provide significant benefits if properly structured and the FAPT has the additional benefits of removing assets from the reach of the US judicial system, which, if we are honest, ain't all that good. If it were, the need for asset protection would not be near as important as it is. I also want to point out that the drafting techniques that make the FLAPT (mentioned above) so effective as an asset protection tool can also be incorporated into DAPTs or FAPTs thereby supercharging their effectiveness and minimizing some of their downsides.

What Control Can a Settlor Have Over Assets Held in an Irrevocable Trust?

As mentioned at the beginning of this article, most people think of irrevocable trusts as being fixed, unchangeable things which eliminate your control over assets. This is not the case. Next I want to look at some of the things the Settlor of an irrevocable trust can do. The primary factor determining how much control a Settlor can have with respect to a trust is whether or not they wish for the assets to be transferred to the trust to be removed from their estate for estate tax purposes. To understand why this is, I am now going to explain what assets are included in your "taxable estate" for federal estate tax purposes, and what it means to make a "completed gift" or an "incompleted gift" for purposes of the federal gift tax laws.

[2] Unlike DAPTs and FAPTs, a wonderful alternative to them (the Florida Asset Protection Trust ("FLAPT")) is based on techniques which have been around for over a hundred years and which have a rich history of case law behind them thereby lessening the uncertainty factor. FLAPTs also cost less than $5,000 to create, and do not require the use of an out of state Trustee (in fact the Settlor can even be the Trustee in certain circumstances). This means not annual fee is necessary to keep the trust effective and the loss of control can be lessened.

What Your Taxable Estate Consists Of.
When you die, if your "estate" contains assets whose combined value exceed a threshold amount (called the "unified credit"), then you are liable to pay estate taxes. The unified credit is presently $5,000,000 per person but is scheduled to drop down to $1,000,000 on January 1, 2013. Determining what assets are contained in your estate starts off very straight forward; every asset owned by you located anywhere in the entire world is yours for estate tax purposes. But then there are some less straight forward additions. Without delving into all the complexities on this topic, if you make a gift (i.e., you transfer property to a person, trust, etc.) but retain the ability to "control or enjoy" the gifted property, then that asset is added back in to your estate. For example, if I own a house and sign a deed that transfers it to you, I have made a gift of that house and it generally would not be included in my estate when I die. BUT if you and I have an agreement that gives me the right to continue to live in the home or choose which people can do so, the value of the home is pulled back into my estate and could be subject to estate tax REGARDLESS of the fact that the deed to that property is in your name.

The Competed Gift.
The term "completed gift" refers to a gift of money, property, etc. where no control is retained by the gift maker (i.e., the donor). This effectively removes that asset from your taxable estate if you were to later on. Going back to the house example, if I simply deeded you a house I own with no strings attached, then a "completed gift" has been made (and the house would no longer be included in my estate).

So why wouldn't you want all gifts to be completed gifts? Because of a "little" something called the federal gift tax. Each time you make a completed gift, the value of the gift is subject to gift taxation (which is presently 35% and scheduled to increase to 55% in 2013), unless some exemption applies. The three big exemptions from gift tax are (1) the "annual exclusion" which presently allows each person to make gifts of $13,000 per year to as many people as they like; (2) paying for another person's health care expenses, and (3) paying for another person's education expenses. If the gift is not fully exempt, then it first reduces your unified credit. If the unified credit is $1,000,000 and you make a gift of $600,000, the you only have $400,000 of that credit left to protect assets from estate taxes. Even worse, if you make a gift that exceeds $1,000,000, then you have to pay gift tax, not when you die, but by April 15 of the next calendar year.

Going back to the example of the Brady Family Irrevocable Trust, assume that the combined value of the cash, rental property, and the LLC interest Mike transferred to the Brady Family Irrevocable Trust equals $3,000,000, and the unified credit is only $1,000,000. If the gift is a "completed gift," the first $1,000,000 would pass gift tax free, and the remaining $2,000,000 would be taxed at the then current gift tax rate. If that rate were 50%, the trust would end up with $2,000,000 and the IRS would get a cool $1,000,000. Not something most people want to do.[3]

[3] See my article entitled "Temporary Estate Tax Fix Creates Golden Opportunity to Permanently Protect Your Assets From Creditors and Estate Taxes" to read about exciting planning that takes advantage of the temporary $5,000,000 unified credit to permanently shield your assets from both estate taxes and creditor claims.

The Incompleted Gift.

Irrevocable trusts are very handy things and can serve a myriad of purposes other than just removing assets from your estate. During your life, they can protect the trust assets from creditors, increase the range of investments vehicles you can available to you, maintain your privacy by keeping your name off the public record with respect to real estate and business interests, and protecting your self from certain types of liability stemming from real estate like homeowner association dues. If you ever become disabled, a trust can ensure that the people you love are provided for in accordance with your specific instructions, the assets are managed properly by people you trust, and provide for successors to step in a manage a business of yours. When you die, a trust allow assets to pass to family members free of the probate process, makes sure that businesses you might own survive your death (or at least retain the value until they can be sold) by appointing individuals or committees to keep them running smoothly, use both spouse's unified credit thereby doubling the amount that can pass to kids estate tax free, and ensures your assets pass to your spouse and children in a way that protects them from creditors, divorcing spouses, and even them selves.[4] And this is just a very small sample of the useful things trusts can do.

With all these non-tax benefits of irrevocable trusts, you can why people might want to use a trust and not have to worry about the immediate gift tax implications of transferring assets to them. Unfortunately, the type of irrevocable trust that most people have been exposed to is the Irrevocable Life Insurance Trust ("ILIT")to which a completed gift must me made. In addition, because many estate planning attorneys are notorious for being overly cautious in the way they draft their ILIT trust agreements (due to partly to a lack of knowledge about the flexibility they can contain and partly because its just easier), people have been exposed to these trusts limits rather than their possible uses. I'll return to the topic of irrevocable trusts designed to remove assets from your estate in a minute, but first I want you to go back to the list of non-tax advantages listed above. It's not hard to see how irrevocable trusts could be very useful even if estate tax reduction was not a goal. In fact, I believe that if the estate tax were repealed altogether, the use of trusts would increase rather than decrease. This is due to the fact that (i) more non-tax attorneys could help their clients create them, and (ii) certain limits placed on trust flexibility would be removed making them even more flexible.

So how can you make a gift to an irrevocable trust without it being considered a taxable "completed gift?" Think back to my example of the gift of the house. If I gave you a house by signing over the deed, but retained the right the live in that home, decide those people who can, or mandate if and when the home is ever sold, the property would be included in my estate. So it wouldn't be fair for the gift to be subject to BOTH estate and gift tax, would it? The way this unfair result is resolved by the tax laws, is for the gift to be considered an "incompleted gift." Think of what this means. I legally transferred the property to you, but never made a taxable gift (even if the home were Bill Gates' $150,000,000 mansion, Xanadu 2.0). The house is now yours, but despite my ongoing control over its use, etc., if I were sued in the future, the house is not mine for my judgement creditor

[4] See my article on planning for your children's future where I discuss Incentive Trusts and other planning to make sure your kids have the best shot of becoming responsible, self sufficient, and happy adults.

to take. Now lets take it a step further and go back to the example of the Brady Family Irrevocable Trust.

Estate Tax Neutral Planning.
Mike Brady has no present creditor issues on the horizon, but fears that if the economy gets any worse, his architect firm might fail and the assets he worked hard to amass over the years could end up in the hands of banks and other creditors. He understands that the trust could protect his assets but also knows that if he makes a completed gift to the trust, he would have a huge gift tax bill. So what's the answer. The Brady Family Irrevocable Trust is created by Mike for the benefit of Carol and the kids just like before, but this time the trust agreement is drafted to give Mike a "Special Testamentary Power of Appointment" over the trust assets. This is just a lawyer's way of saying that after Mike transfers assets to the trust, he keeps the power to (i) change the people who will receive the trust assets when he dies, (ii) change the percentages and/or dollar amounts each beneficiary will get, and (iii) the manner in which each beneficiary will inherit their assets (e.g., a restrictive trust, an unrestrictive trust, outright and free of trust, a trust that makes monthly payments, a trust that rewards good grades, hard work, or other admirable behavior, etc.). This is enough retained control to ensure that the gifts of cash, real estate, and business interests will be "incomplete gifts" with no gift tax being triggered.

Note first that since Mike is not a beneficiary of the Brady Family Irrevocable Trust, the trust will protect assets not only from his creditors but from those of Carol and the kids. The assets will be included in Mike's estate for estate tax purposes but if that is not a concern of his (maybe the assets are less than the combined unified credits of he and Carol, if he thinks the assets will be largely depleted by the time he dies, etc.), he still derives all the other advantages trusts can provide (e.g., no probate, business succession planning, avoiding guardianship, estate tax reduction by using both spouse's unified credit, passing assets on to kids in a way that protects them from creditors, divorcing spouses, etc.). Also note that if Mike and Carol need the trust assets to live on, the trust can still distribute assets to Carol without any adverse tax consequences. This is because married couples are allowed to makes gifts of an unlimited amount to each other without paying any gift tax. And since the assets in the trust are in essence passing from Mike (who never made a completed gift) to Carol, his wedded bride, no gift tax is triggered when distributions are made to her.

But what if Mike wants full control over the trust assets? Well, Mike (the Settlor) can serve as the Trustee of the trust. This means that he can directly control all of the trust assets. For example, Mike as Trustee will be able to manage the cash in the bank account, write checks, invest the cash in stocks, bonds, mutual funds, etc., use the cash to buy real estate or business interests, use the cash to start a business (like an LLC) which will be owned by the trust, vote the shares in any business held in the trust, manage the rental property (e.g., decide whom to rent to, the rental amounts, etc.), and whether to sell the rental property and/or the business (and how to invest the proceeds from any such sale). Mike and Carol can even serve as Co-Trustees so they can both do these things or do them as a team. And remember that being a Trustee does not subject the trust assets to the claims of either Mike's or Carol's creditors (or event joint creditors).

We know that Mike can revise how the trust assets are distributed when he dies because of the Special Testamentary Power of Appointment, but what about Carol? If Mike became disabled or died, could she make the same kinds of changes? If the Brady Family Irrevocable Trust is drafted to give her a Special Testamentary Power of Appointment, the answer is Yes. And what if changes need to be made to the trust before Mike and Carol die; for example to add or subtract beneficiaries, change the jurisdiction of the trust, adopt to changing tax or asset protection laws, etc? Mike could appoint someone other than himself or Carol to make these changes; say a sibling, parent, or close friend. This person is sometimes called a "Trust Protector" and their powers typically require the settlor's consent before they are exercised.

I hope you are starting to see that irrevocable trusts are not some "Rock of Gibralter" that once put in place limits your ability to control, manage, use and enjoy the trust assets. I know that many of you may be wondering how Mike could get assets back out of the trust if he needs money and Carol has died, become disabled, or divorces Mike? Or what if Mike was a single guy with no spouse to begin with? I will answer these questions shortly, but first I want to summarize what we have covered so far.

Irrevocable trusts can be used to effectively shelter assets from creditors claims, and still allow the trusts creator to:

1. Be the Trustee thereby retaining full control over the trust assets, how they're managed, how stock is voted, when they are bought and sold, how the sale's proceeds will be reinvested, etc.;
2. Gain access to the trust assets to live on by virtue of the settlor's spouse being a beneficiary;
3. Alter which people will receive the trust assets (and in what manner) when the settlor dies thereby retaining the right to modify their estate plan to adjust to changing circumstances; and
4. A Trust Protector (typically a trusted friend or family member) can add or subtract beneficiaries, change the jurisdiction of the trust, and make other changes to the trust during your life (which you can also veto).

Estate Tax Planning.
If Mike wanted to make a gift of assets to the to the trust and have it treated as a "completed gift" for federal gift tax purposes so that the assets (and all the future growth and income from those assets) would escape estate taxation when he ultimately passes on, the two primary powers he could not retain are (i) the ability to serve as the Trustee of the Trust, and (ii) the ability to retain the Special Testamentary Power of Appointment. If Mike is married, as our example assumes, Carol could both (i) act as the Trustee, and (ii) have a Special Testamentary Power of Appointment allowing her to change how the kids inherited assets. The Trust Protector could also have a Special Testamentary Power of Appointment which could be used to change how assets are distributed when Mike dies. This could be very helpful if Carol dies or becomes disabled.

Therefore, if Mike and Carol's marriage is strong and Mike has a high level of trust in his wife to do what's best for their family, the only practical difference in flexibility is that Mike could not directly manage assets and/or make decisions on how much money is distributed from the trust to beneficiaries. All of the other benefits listed above could be obtained and still remove the assets from Mike's and Carol's estate.

But there is even a way to solve the "management of assets" issue for Mike. If instead of gifting assets directly to the trust, Mike could first transfer the assets to a limited liability company (LLC) which is specially created to have voting and non-voting "shares." The voting shares would only constitute 1% of the total ownership in the LLC and all the non-voting shares (equal to 99% of the LLC) could be gifted to the trust. This way Mike (or Mike and Carol jointly), could manage the trust assets and since the only thing the trust owns is non-voting shares, there is really nothing for the Trustee to do other than make decisions on how and when Trust assets are to be distributed. Once again, even when the objective is to remove assets from estate taxation, the use of an irrevocable trust can allow a couple to maintain substantial control over and ability to use the gifted assets.

A Brief Clarification of the Income Taxation of Irrevocable Trusts.

Before ending this article I wanted to give you a very brief overview of how trusts are taxed for *Income Tax* purposes, as this topic is also widely misunderstood. While my explanation will admittedly be grossly oversimplified, it should help you understand the key elements. There are basically two primary ways trusts are taxed. It is either considered to be a "Grantor Trust" or a "Non-Grantor Trust." If it is considered to be a "Non-Grantor Trust," it will have its own tax ID number (EIN) and will file its own tax return (called a Form 1041). The income produced by the trust will be taxed at trust tax rates. The rates are the same as for individuals BUT the top tax rate is reached very quickly. In 2011, the top rate of 35% is applied to all income over $11,350. The trust, however, is not taxed on any income it distributes to the trust beneficiaries, rather the beneficiaries pay the tax. This can be beneficial if the beneficiary's income tax rate is lower than the trusts. The following example will show how this works. Please note I am going to ignore the graduated tax rates for simplicities sake.

> Assume John creates a Non-Grantor Trust and names his adult daughter, Smowilda, as the beneficiary, and transfers $500,000 to it. The money is invested in CDs that pay 4%. At the end of the year the trust has earned $20,000 in ordinary income. The same year, Smowilda's last dollar of income is taxed at the income tax rate of 25%.
>
> If the trust does not distribute and income to Smowilda, the trust's top tax rate will be 35% and it will pay $7,000 in income taxes.
>
> If the trust instead distributed $9,000 to Smowilda retaining $11,000 in the trust, the trust will pay $3,850 in taxes ($11,000 x 35% = $3,850) and Smowilda will pay $2,250 ($9,000 x 25% = $2,250), for a total of $6,100. Less income tax was paid

because some of the trust income was "carried out" to the beneficiary with the distribution.

Next assume the trust distributed $30,000 to Smowilda using up all the trust income and dipping into $10,000 of the trust's the principal (i.e., the initial after tax dollars gifted to the trust by John). In this case the trust pays zero income taxes because all of its income was carried out to Smowilda. Smowilda paid $5,000 in taxes ($20,000 x 25% = $5,000). The final $10,000 is not taxed at all because the trust is simply distributing after tax dollars to Smowilda.

As I hope you now see, the act of making a distribution from an irrevocable Non-Grantor Trust does not "trigger" any income tax. It simply shifts it from the trust to the beneficiary receiving the distribution. So if the beneficiary is already taxed at the 35% tax rate, no tax savings will be achieved by making a distribution because it will simply pass from the trust (whose paying tax at the 35% rate) to the individual (whose also paying tax at the 35% rate). Also note that the "character" of the income is also carried out. So if the income earned by the trust is part ordinary income, part capital gains, and part tax free income, the individual will pay some tax at the ordinary income tax rates, some at the capital gains rates, and will get the tax free income, well, tax free. I obviously skipped a lot of details, but you should have a better grasp of the topic as a whole.

If an irrevocable trust is taxed as a "Grantor Trust," it is in essence ignored completely for *income tax* purposes. Instead of the trust paying any tax, the settlor (i.e., the person who creates the trust) is taxed *personally* for all income generated inside the trust. Remember, however, that if the trust was drafted to remove assets from your estate, the trust is NOT ignored for Estate Tax purposes resulting in those assets properly transferred to the trust being removed from your taxable estate. Understand that when income and/or capital gains are realized by a Grantor Trust, whoever established the trust is responsible for paying the income taxes. There are numerous advantages for having a trust taxed this way which I discuss in more detail in my article entitled "Temporary Estate Tax Fix Creates Golden Opportunity to Permanently Protect Your Assets From Creditors and Estate Taxes." But do understand that if a Grantor Trust is properly drafted, the Trustee of the trust can give you the money to pay the taxes if need be.

What determines whether a trust is a Grantor Trust or a Non-Grantor Trust is determined by a set of Internal Revenue Code Sections (671-679). If the trust is revocable, then the trust is automatically a Grantor Trust. If the trust is an irrevocable trust, then it could be either a Grantor Trust or a Grantor Trust or a Non-Grantor Trust. It depends on whether the trust agreement was drafted to give the Settlor certain powers or rights. A skilled estate planning attorney can make sure the appropriate rights are either added or omitted to make sure the trust is taxed in the way that best suits your planning needs (i.e., either a Grantor Trust or a Grantor Trust or a Non-Grantor Trust).

Now lets talk about federal tax ID numbers (EINs) for a minute. All Non-Grantor Trusts have to get an EIN. They need it to open bank accounts and file their tax returns. Grantor Trusts, on the other hand, are not *required* to obtain an EIN. This being said, most banks do not require you to get

an EIN for a revocable trust because ALL revocable trusts are Grantor Trusts. But since irrevocable trusts could be taxed EITHER way, and because legal knowledge is required to tell which category a particular irrevocable trust fall into, most banks require all irrevocable trusts to obtain an EIN even if one is not technically needed. This black and white rule saves them from any problems that might arise if a bank employee makes an inaccurate determination. So even though these policies may create extra work for the person settling up a Grantor Trust, it appears to be a necessary step if you need the trust to have bank or brokerage accounts. Thankfully, its not much trouble to do so.

Conclusion.

I hope this article has first helped you see that "Irrevocable" Trusts can serve a whole range of important tax and non-tax purposes like asset protection, estate tax reduction, planning for the future welfare of spouses, children, and other loved ones, probate avoidance, charitable planning, and the list goes on. Second, I hope you better understand what trusts are, and how trusts work in achieving the benefits they do. Third, I hope you better understand that why the irrevocable trust's "irrevocability" is essential in accomplishing the above described benefits. And most of all, I hope you see how flexible they can be if properly drafted by someone who understands the rules and laws that govern them. You can control the how your assets are invested, when things are bought and sold, write checks, change who will inherit your assets, even change aspects of the trust that aren't serving you during your life. The trust can even convert into a completely new trust if necessary. It can also change its "jurisdiction" or location to take advantage of another state's (or country's) asset protection laws, for example.

There is an even more exciting variation of the irrevocable trust that I have saved for another article, that provides you even more power and control over the trust and actually increases the asset protection it provides. I call it the Florida Asset Protection Trust ("FLAPT"). It uses planning techniques based on statutes which have been tested and have rich case law supporting them. Over my sixteen years as an asset protection and estate planning attorney, I've found that sometimes going back to basics can provide clients with the best results. Using tested techniques in unique ways provides more certainty than planning based on newer, less tested laws. If you have any questions about the FLAPT or want to explore whether it would meet your specific needs, please feel free to call my office, or read my upcoming article "Introducing The FLORIDA Asset Protection Trust. Less Expensive, More Protective, No Out of State Trustee Required."

One final thing. On December 17, 2010, President Obama signed into law H.R. 4853, The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. These new laws make significant changes to the gift, estate, and generation skipping transfer tax (GST) laws, but will only be effective for TWO YEARS. Most notably, the unified credit (the amount you can give away or die with without triggering gift or estate tax) was increased to $5,000,000 per person. These new laws are repealed automatically on December 31, 2012, leaving us with the old estate tax laws which have a top estate tax rate of 55% and only provide for a $1,000,000 unified credit. Using a flexibly structured irrevocable trust (including, a FLAPT), could allow a married couple to remove not only $10,000,000 from their taxable estate but also all the future growth on those assets and all the and income they produce. This can amount to a very large savings over the rest of your life. To learn

more about these new laws, see my article entitled “Temporary Estate Tax Fix Creates Golden Opportunity to Permanently Protect Your Assets From Creditors and Estate Taxes.”

The above mentioned articles can be found on the Kirwan Law Firm website at KirwanLawFirm.com There you can read other article such as “Why The "P.A." Is The Worst Legal Entity To House Your Medical Practice,” and “What To Do If Your Upside-Down on Real Estate.”