Trust Basics and Lagniappe

Practice Areas
- Trusts

I. Trust Purposes

A. Asset Management and Preservation

B. Income Tax Savings

C. Estate and Gift Tax Savings

D. Asset Protection from Creditors

E. Splitting Beneficial Economic Interests

F. Avoidance of Probate

II. Types of Trusts

A. Trust Created by Will

A trust is testamentary when it is created by donation mortis causa. (R.S. 9:1733). A mortis causa donation is one made by will.

B. Trust Created During Lifetime

All trusts not testamentary are considered inter vivos, regardless of the time of creation. (R.S. 9:1734). An inter vivos donation is one made during lifetime.

C. Irrevocable Trust

An irrevocable trust is one in which no one has the power to revoke the trust. However, an irrevocable trust could include a power to modify the trust in designated ways.

D. Revocable Trust

A settlor may reserve the right to modify or revoke a trust to the extent that the settlor expressly reserves the right to do so. (R.S. 9:2021)

E. Class Trust

A Class Trust is a trust in favor of a class consisting of some or all of a settlor's descendants or descendants of a collateral relative of the settlor, although some of the members are not yet in being at the time of the creation of the trust provided at least one member of the class is in being. (R.S. 9:1891). This trust may be either created by will, during lifetime, irrevocable or revocable. This special type of trust was created by the Louisiana legislature to make exceptions to the general requirements that all beneficiaries must be in being on the date of the creation of the trust.

III. Parties to a Trust

A. What is a trust?

A trust is the relationship resulting from the transfer of title to property to a person to be administered by him as a fiduciary for the benefit of another. (R.S. 9:1731). Most people consider a trust to be an entity even though statutorily it is only a relationship.

B. Who creates the trust?

A settlor is a person who creates the trust. A person who subsequently transfers property to the trustee of an existing trust is not a settlor. (R.S. 9:1761). Other terms used interchangeably with settlor are grantor or trust creator.

C. Number of Settlors

There may be one or more settlors of an inter vivos trust. (R.S. 9:1762).

D. Who may be settlor of inter vivos trust?

A person having capacity to contract by onerous or gratuitous title may be a settlor of an inter vivos trust. (R.S. 9:1763).

E. Who may be settlor of testamentary trust?

A natural person having capacity to make a donation mortis causa may be the settlor of a testamentary trust. (R.S. 9:1764).

IV. What may be transferred to a trust or acquired by a trust?

A. General Rule

Property susceptible of private ownership, and any interest in such property may be transferred in trust. (R.S. 9:1771).

V. How is a Trust Managed?

A. Trustee Defined

A trustee is a person to whom title to the trust property is transferred to be administered as a fiduciary. (R.S. 9:1781).

B. Number of Trustees

There may be one or more trustees. (R.S. 9:1782).

C. Who may be trustee?

Only the following persons or entities may serve as a trustee of a trust established pursuant to the Louisiana Trust Code:

1. A natural person enjoying full capacity to contract who is a citizen or resident alien of the United States.

2. A federally insured depository institution organized under the laws of Louisiana, another state, or of the United States, subject only to the restrictions applicable to national banks or a trust company organized under the laws of Louisiana.

3. A nonprofit corporation or trust for educational, charitable, or religious purposes that is designated as

income or principal beneficiary may serve as trustee of a trust for mixed private or charitable purposes. (R.S. 9:1783).

D. Manner in Which Trustee Chosen

An original trustee, an alternate trustee, or a successor trustee may be designated in the trust instrument or chosen by the use of a method provided in the trust instrument, but neither failure of the trust instrument to so provide nor disqualification or removal of the trustee for any reason, incompetence or unwillingness to at of the person so designated or chosen shall invalidate the trust. In such a case, the proper court shall appoint one or more trustees. (R.S. 9:1785).

E. Removal of Trustee

A trustee may be removed in accordance with the provisions of the trust instrument or by the proper court for sufficient cause shown. (R.S. 9:1789).

VI. Who benefits from a trust?

A. Beneficiary Defined

A beneficiary is a person for whose benefit the trust is created and may be a natural person, corporation, partnership, or other legal entity having the capacity to receive property. A trustee of a trust, in his capacity of trustee, can be the beneficiary of another trust. (R.S. 9:1801).

B. Requirement that Beneficiary be in Being and Ascertainable

A beneficiary must be in being and ascertainable on the date of the creation of the trust, except as otherwise provided in this Code. An unborn child is deemed a person in being and ascertainable, if he is born alive. (R.S. 9:1803).

C. Settlor as Beneficiary

A settlor may be the sole beneficiary. (R.S. 9:1804).

D. One or Several Beneficiaries; Separate Beneficiaries

There may be one beneficiary or two or more beneficiaries as to income or principal or both. There may be separate beneficiaries of income and principal, or the same person may be a beneficiary of both income and principal, in whole or in part. (R.S. 9:1805).

E. Successive Income Beneficiaries

Several beneficiaries may be designated to enjoy income successively. (R.S. 9:1807).

F. Term of the Trust

If the trust instrument stipulates a term and unless an earlier termination is required by the trust instrument, or by the proper court, a trust shall terminate at:

1. The death of the last surviving income beneficiary or the expiration of twenty years from the death of the settlor last to die, whichever last occurs, if at least one settlor and one income beneficiary are natural persons;

2. The death of the last surviving income beneficiary or the expiration of twenty years from the creation of the trust, whichever last occurs, if none of the settlors is a natural person but at least one income beneficiary is a natural person;

3. The expiration of twenty years from the death of the settlor last to die, if at least one settlor is a natural person but none of the income beneficiaries is a natural person;

4. The expiration of fifty years from the creation of the trust, if none of the settlors and none of the income beneficiaries is a natural person.

(R.S. 9:1831) However, the term of a trust established as a Class Trust may, as a practical matter, be established in perpetuity in the event that the income beneficiary consists of some or all of the settlor's descendants and the principal beneficiary is a charity. Since the income interests continue in perpetuity, the principal beneficiary may never receive any assets from the trust.

G. Nature of Interest

An interest in income may be given absolutely or conditionally. It may be given for the life of a beneficiary or for a term, certain or uncertain, not exceeding the life of a beneficiary.

A settlor may allocate to a beneficiary of income a portion of income. Any income not allocated to an income beneficiary shall be allocated to principal.
Except as otherwise provided with respect to the legitime in trust, a settlor may give a trustee who is not a beneficiary of the trust discretion without objective standards except that of the average reasonable man to allocate income in different amounts among the income beneficiaries or to allocate some or all of the income to principal. The settlor may allow income that is not allocated by the end of the year in which it is received to remain unallocated by the trustee until a future year. Any income unallocated when the trust terminates shall be allocated to principal. (R.S. 9:1961).

H. Distribution of Income

In the absence of a contrary stipulation, income shall be distributed to the designated beneficiary at least every six months. (R.S. 9:1962).

I. Permissible Stipulations Regulating Distribution of Income

Except as otherwise provided with respect to Class Trusts and the legitime in trust, a settlor may stipulate when the income allocable to a designated beneficiary shall be distributed to him, or he may stipulate that the trustee has discretion to determine the time or frequency of distribution or to accumulate some or all of the income. (R.S. 9:1963).

J. Termination of Income Interest; Undistributed Income

An interest in income terminates upon the death of the designated beneficiary, or at the expiration of the period of his enjoyment if the interest is for a period less than life. At the termination of an income interest, accumulated

or undistributed income that has been or is required to be allocated to the beneficiary shall be paid to the beneficiary or his heirs, legatees, assignees, or legal representatives, except as otherwise provided in this Code. (R.S. 9:1964).

K. Effect of Termination of Interest

Termination of the interest of the sole income beneficiary prior to the termination of the trust causes each principal beneficiary to become a beneficiary of income in an amount proportionate to his interest in the principal, unless the trust instrument provides otherwise. Termination of an interest in income of one of several income beneficiaries causes the other income beneficiaries or their successors to become beneficiaries of that interest in income in proportion to their interests in the balance of trust income, unless the trust instrument provides otherwise. (R.S. 9:1965).

L. Treatment of Income Upon Death of Principal Beneficiary

Upon a principal beneficiary's death, his interest vests in his heirs or legatees, subject to the trust; provided, however, that the trust instrument may stipulate otherwise to the extent permitted under prescribed circumstances when a beneficiary dies intestate and/or without descendants. (R.S. 9:1972).

M. Shifting Interest in Principal

The trust instrument may provide that the interest of either an original or a substitute principal beneficiary who dies intestate and without descendants during the term of the trust or at its termination vests in some other person or persons, each of whom shall be a substitute beneficiary.

Except as to the legitime in trust, the trust instrument may provide that the interest of either an original or a substitute principal beneficiary who dies without descendants during the term of the trust or at its termination vests in some other person or persons, each of whom shall be a substitute beneficiary. (R.S. 9:1973).

N. Substitute Beneficiary's Interest may be Conditional

The interest of a substitute beneficiary may be conditioned upon his surviving the principal beneficiary. The trust instrument may provide for one or more alterative substitute beneficiaries if a substitute beneficiary does not survive the principal beneficiary. (R.S. 9:1974).

O. Requirement that Substitute Beneficiary be in Being and Ascertainable

Except as otherwise provided by statute, a substitute beneficiary must be in being and ascertainable on the date of the creation of the trust. Two exceptions to this include the income beneficiaries of a Class Trust and when provision is made for a substitute principal beneficiary. (R.S. 9:1975).

P. Treatment upon Death of Substitute Beneficiary Whose Interest in Not Conditioned on Survival

Upon a substitute beneficiary's death, his interest, if not conditioned on survival, vests in his heirs or legatees subject to the trust. (R.S. 9:1976).

VII. Irrevocable Life Insurance Trust

A. Use

An irrevocable life insurance trust is an excellent and extremely popular wealth preservation planning tool. It is probably the most used of all trusts. This trust can be used to fulfill all of the Trust Purposes set forth in Section I. It can be tailored to the specific goals, needs and problems of a particular client. This trust is usually not funded. The settlor is usually the insured. The trustee is frequently the insured's spouse. The settlor's spouse is usually the trust income beneficiary and the settlor's children are usually the trust principal beneficiaries. If the trust designates grandchildren as principal beneficiaries, then a generation skipping transfer tax analysis is required.

B. Primary Purpose

The primary purpose of many, if not most, irrevocable life insurance trusts is to provide the settlor's spouse with a life income interest and the settlor's descendants with the invested insurance proceeds subsequent to the death of the settlor's wife without the policy proceeds being taxable in either the settlor's estate or the estate of the settlor's spouse. A settlor can achieve this objective with proper planning.

C. Trustee

The settlor's spouse may be the trustee if limitations are placed upon the trustee against invading and distributing principal.

One principal invasion term that is satisfactory authorizes the trustee to make distributions of principal at such times and in such amounts as the trustee determines, in his or her sole discretion, to provide for the income beneficiary's support, maintenance and medical needs in accordance with the income beneficiary's accustomed standard of living. In the event that the trustee's powers of invasion are too broad, then the trust principal may be taxable in the trustee's estate.

D. Pitfalls

1. Crummey Powers

Only gifts of present interests in property are eligible for the federal annual gift tax exclusion of $12,000. Outright gifts of life insurance policies are gifts of a present interest but the interest of an income beneficiary may be considered a future interest since life insurance is not income producing. Therefore, each principal beneficiary must be given the right of withdrawal of an amount equaling the annual contributions made to the trust for such beneficiary's benefit. This withdrawal right must be real and not illusory and the beneficiary must be properly notified. In the event that a settlor creates an irrevocable life insurance trust which does not include a crummey power, then the settlor will not be eligible for the federal annual gift tax exclusion.

2. Premiums

The trust should prohibit utilizing trust income to pay insurance premiums. The insurance premiums are best paid by annual donations from the settlor.

3. Three Year Rule

If an insured transfers a policy to a life insurance trust or relinquishes retained incidents of ownership within three years of death, the policy proceeds will be includable in the insured's gross estate. However, if a new policy is acquired directly by the life insurance trust from the insurer, the policy proceeds will not be includable in the insured's gross estate, even if it is acquired within three years of the insured's death.

4. Generation Skipping Transfers

Be careful! It may be necessary to file a gift tax return and make an appropriate election annually in order to prevent the policy proceeds and the accumulated earnings thereon from becoming a taxable generation skipping transfer.

E. Step by Step Process

The irrevocable life insurance trust is one of the most efficient means of achieving a variety of estate planning goals, provided that the trust is carefully drafted and properly implemented.

The execution of the life insurance trust and the acquisition of the insurance should follow a series of steps which must take place in the proper sequence so that the tax driven estate planning goal can be achieved.

1. Determine if the client is insurable.

2. Obtain medical examination of insured.

3. If the insurance company will not permit a medical exam without a policy application, have someone other than the insured sign the application, preferably the party ultimately to be selected as trustee.

4. Determine the appropriate amount of coverage and the applicable annual premium level.

5. Design the trust to conform with the client's needs. Select:

a. Appropriate crummey clause for the annual premium amount;

b. Trustee; and

c. Beneficiaries.

6. Execute the trust and obtain tax identification number.

7. The trustee executes the policy application or amended application.

8. The insured writes a check to the trustee in an amount equal to the required premium.

9. The trustee opens a bank account in name of the trust using the trust's federal identification number and deposits the donated check.

10. The trustee issues the crummey notice(s) and awaits the required notice delay period set forth in the trust and in the notice.

11. Only after the crummey delay has elapsed should the trustee pay the premium to the insurance company.

VIII. Wealth Replacement for a Charitable Remainder Trust

A. Structure

1. Donor transfers cash or appreciated property to an irrevocable inter vivos or testamentary trust.

2. The income beneficiary is a non-charitable beneficiary, usually the donor, donor's spouse or children, etc.

3. The principal beneficiary is a qualifying charity.

4. The term of the trust is either for the life or joint lives of the income beneficiary(ies) or a term of years, not to exceed 20.

B. Types of Charitable Remainder Trusts

1. Annuity Trust. Pays a specified dollar amount each year to the non-charitable income beneficiary; but not less than 5% of the initial FMV of property placed in trust. Income shortfalls must be made up from corpus. Subsequent contributions are prohibited. Shifts in future values of trust assets affect the charity only.

2. Unitrust. Pays a specified percentage of the value of the trust principal each year to the non-charitable income beneficiary. Income shortfalls may be made up from corpus in future years. Subsequent contributions are permitted. Shifts in future value affect both the charitable and non-charitable income beneficiary.

C. Transaction Tax Effect

The donor will receive an income and gift tax deduction for inter vivos gifts and an estate tax deduction for testamentary gifts equal to the present value of the charity's remainder interest, which will depend upon a number of factors including:

1. The value of the property transferred to the trust;

2. The age of the non-charitable income beneficiary or beneficiaries (if for life) or the term of the trust;

3. The amount of the annuity or the percentage of the unitrust interest;

4. The frequency of payments;

5. The required applicable federal interest rate.

D. Purpose

The donor may receive substantial benefits from creating a charitable remainder trust such as:

1. Avoidance of capital gains taxes

2. Ability to convert non-income producing appreciated assets into income producing assets without incurring capital gains taxes.

3. Increased income.

4. Income tax savings

E. Taxation of Trust

The income beneficiary's annuity or unitrust payment is treated as having the same characteristics as the trust's income, in the following order:

1. ordinary income, then

2. capital gain, then

3. other (tax-exempt) income, then

4. corpus.

A charitable remainder trust is a tax exempt trust and, consequently, pays no income tax of its own, nor will the charitable principal beneficiary.

F. Life Insurance Use

1. A life insurance policy on the donor is a good investment vehicle for a spousal charitable remainder unitrust, particularly when the unitrust provides that income deficiencies may be distributed in later years; i.e., after the death of the insured. Prior to the death of the settlor, the trust may have no income. However, after the receipt of life insurance proceeds, it should then generate income for the surviving spouse.

2. The donor utilizes the income tax saving created by funding a charitable remainder trust to purchase life insurance naming the insurance beneficiaries as the policy owner. This wealth replacement method can result in the donor's beneficiaries receiving a larger after-tax inheritance than if the donor did not create a charitable remainder trust. The donor can acquire additional insurance by funding it with the increased annual income earned by the donor from his or her charitable remainder trust.

IX. Dynasty Trusts

A. Definition

A "dynasty" trust (a/k/a "legacy" or "perpetual" trust) is a long-term trust designed to last for specific or unlimited future generations. Up until recently, most American states and offshore trust domiciles limited the duration of a trust. This limited duration period was based upon a doctrine enacted in 1536 and known as the "Rule Against Perpetuities." At least twelve states have now either abolished the Rule Against Perpetuities or specifically permit the term of a trust to expire at a later date than previously allowed.

B. Permissible Louisiana Dynasty Trusts

Except for a Class Trust, Louisiana prohibits a trust from extending after the later of the death of the last income beneficiary or twenty years after the settlor's death and requires that the beneficiary be in being and ascertainable on the date of the creation of the trust. Therefore, except for a Class Trust, a Louisiana trust may not last for more than the lifetime of a designated beneficiary, in being at the time of the creation of the trust or twenty years after the settlor's death (R.S. 9:1803, 9:1831 and 9:1834).

C. Term of Louisiana Class Trust

1. La. R.S. 9:1831 provides that a trust terminates upon the death of the last surviving income beneficiary or twenty years after the settlor's death, whichever last occurs. The term "surviving income beneficiary" would include a principal beneficiary who is designated as a beneficiary of income in the future or who becomes entitled to enjoy income because of the termination of the rights of an income beneficiary. La. R.S. 9:1835. However, subpart H of part I of the Trust Code dealing with the maximum permissible term of a trust does not apply to Class Trusts or to mixed private and charitable trusts. La. R.S. 9:1834.

2. A Class Trust does not terminate before the class closes. La. R.S. 9:1897. The trust may state a date or method for defining a date when the class closes. Unless the trust provides otherwise, the class closes when no members can be added. La. R.S. 9:1896. Once the class closes, the general rules applicable to the permissible term of a trust apply. La. R.S. 9:1897.

3. La. R.S. 9:1901 provides that after the class closes, the trust does not terminate until the death of the last surviving member of the class, unless the trust stipulates an earlier termination date.

D. 1997 Class Trust for Descendants

La. R.S. 9:1891 permits the creation of trusts in favor of a class consisting of some or all of a settlor's children, grandchildren and great grandchildren, or nieces/nephews, grand nieces/nephews or great grandnieces/nephews, although some members of the class are not yet in being at the time of creation of the trust, provided at least one member of the class is then in being. Thus a "limited" dynasty trust could be created under Louisiana Law. True dynasty trusts must be created under other state laws, such as Alaska or Delaware, for example.

E. Distributions to Class Income Beneficiaries

1. The trust can provide when income is distributed to the class of income beneficiaries, or it can provide the trustee with the discretion to determine the time or frequency of income distributions or to accumulate some or all of the income. La. R.S. 9:1899. However, income attributable to the legitime in trust must be payable not less than once each year. La. R.S. 9:1841.

2. Generally, if the class consists of persons in more than one generation, then their interests are equal by heads, unless the trust provides otherwise. La. R.S. 1891B.

3. A non-beneficiary trustee may, without objective standards except that of the average reasonable person, allocate income in different amounts ("spray" provisions) among the income beneficiaries and to allocate some or all of the income to principal. La. R.S. 9:1961C.

4. A trustee may invade and distribute accumulated income and principal for the income beneficiary's support, maintenance, educational, or medical expenses, or, pursuant to an objective standard, for any

other purpose. La. R.S. 9:2068.

5. The trust may provide that if a class beneficiary dies without descendants, his or her interest vests in the other members of the class. La. R.S. 9:1895A. However, this provision would not give a member of the class of income beneficiaries a right of testamentary transfer to others just because he/she has descendants, since, by definition, his/her income interest terminates upon death.

F. Distributions to Class Principal Beneficiaries

1. Generally, the interest of a principal beneficiary is immediately vested upon the creation of the trust. La. R.S. 9:1971 and 9:1891A. This doctrine was initially eroded with the introduction of the Class Trust concept. The class could be defined as the principal beneficiaries of the trust, which means that after born members of the class dilute the interests of the existing principal beneficiaries. Furthermore, the Trust Code provided a limited substitution whereby the interest of a member of the class of principal beneficiaries could shift to the other class members where the beneficiary died intestate and without descendants. La. R.S. 9:1973A. This provision was further amended in 1997 to permit a shift (except as to legitime) to other class members if the beneficiary merely died without descendants, regardless of whether the beneficiary had a will. La. R.S. 9:1973B.