Designing and Drafting Irrevocable Trusts

By Tim Voorhees

On 12/17/10, the President signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. This legislation restores the estate tax for 2011 and 2012, after its one-year repeal in 2010, and sets a top rate of 35% and $5 million per individual exemption amount. These new rules create a two-year window of opportunity for clients who fund irrevocable trusts. Clients may have a once-in-a-lifetime opportunity to fund trusts that leverage the $5 million gift tax exemption. Properly designed, drafted, and funded irrevocable trust can now transfer tens of millions of dollars to beneficiaries without gift, estate, or generation-skipping transfer taxes. As a result, more than 1 million Americans with assets over $5 million should have renewed interest in irrevocable trusts.

Irrevocable trusts are separate legal entities that hold clients' assets outside of their taxable estates. These entities can allow assets to grow tax-efficiently and benefit from asset protection or other dynasty trust features. Such trusts come in many different flavors. For example there are Qualified Personal Residence Trusts ("QPRTs"), Grantor Retained Annuity Trusts ("GRATs"), Intentionally Defective Irrevocable Trusts ("IDITs"), and literally more than a dozen other popular irrevocable trusts used for estate and gift tax planning.

Drafting irrevocable trusts creates numerous challenges that are not as apparent when lawyers draft traditional revocable trusts. In particular, the irrevocable trust interview sheets tend to have many more questions. Each question may have a half dozen or more answers. Doing the math, a lawyer sees that just 40 different questions, each with 6 different possible answers on average, can result in more than 31 nonillion (31 followed by 30 zeros) different options. The attorney needs much wisdom when focusing on the choices most consistent with the client's needs and desires.

If the attorney does not take the time to design the irrevocable trust correctly, the client may be irrevocably unhappy. While there are several ways to make irrevocable trust plans de facto revocable, and there are various ways to modify irrevocable trusts, changing an irrevocable trust creates numerous challenges. Therefore, it is especially important that the attorney carefully design the irrevocable trust provisions before drafting commences. The remaining portion of this article will consider how lawyers should evaluate six dimensions of trust design and communicate trust benefits using pictures, numbers, and text.

Six Dimensions of Trust Design

Just like solving Rubik's cube requires careful calculations involving interrelationships of puzzle pieces on six sides, the irrevocable trust drafter must address all six dimensions of the drafting challenge. The drafting attorney should begin with a complete summary of resources, unite advisers and family members around a shared vision for using the client's resources, develop a plan for the advisers to work as a team, illustrate how the trust provides the right amount of cash for lifetime income and/or inheritance amounts, draft the dispositive provisions to give appropriate control without unnecessary taxes, and anticipate all of the issues related to maintaining the trust and educating future trustees and/beneficiaries.

Design	**Illustration**
Resources	Balance sheet
Relationships	Vision Statement
Governance	Consent Grid
Values	Cash Flows
Dispositive Provisions	Flow Charts
Maintenance/Education	Next Action List

So that the attorney addresses the six dimensions of trust drafting without overlooking important issues, clients should ask for an illustration of the proposed trust. First, a balance sheet should list each asset in the trust along with details about basis, ownership, yield, beneficiaries, intentions, debt, and asset allocation proxies. Attorneys will often welcome the assistance from a qualified wealth adviser with developing a detailed balance sheet that can guide accurate projections of potential after-tax payments to grantors or beneficiaries.

Second, if the balance sheet shows any significant amount of assets, it is likely that the patriarch, matriarch, or other family members will have different ideas about how to use the assets across the decades or in future generations. To unite family members around a shared vision, a wealth counselor may lead a retreat among stakeholders. This process of fostering a shared vision may take several hours or longer. Increasingly attorneys work with wealth counselors to develop commitment among decision makers to a vision statement that can inspire a mission statement as well as ranked and quantified objectives that guide document drafting.

Third, the wealth coach may unite the CPA, financial planner, and other advisers around a shared understanding of the roles and goals of each adviser. Thoughts about governance are summarized on a grid signed by the client to allow sharing of information amount advisers. The consent grid should indicate which advisers will know about meetings, access next action checklists, and/or view confidential documents. If family members or advisers encounter confusion about their roles, a wealth coach may use a project management process to provide guidance about roles and goals of each team member.

Fourth, as the attorney determines which assets should go into the trust, he or she should develop projections regarding future payments from trust assets. The cash flow projections should look at quarterly or annual payments before and after taxes while answering the most important question in trust design and drafting: “how much is enough?” When projecting the correct amount of trust distributions each year, the tax lawyer should consider trust design issues while a wealth adviser considers portfolio design issues that impact risk-adjusted, after-tax cash flow. Close collaboration between the estate design expert and portfolio design expert is critical because of how decisions made by either person can have such a large impact on cash flow. With proper integration of ideas, estate optimization combines with portfolio optimization to produce wealth optimization solutions.

Fifth, flowcharts should illustrate how the trust fits into an estate or financial plan. Irrevocable trust drafting software provides huge numbers of options regarding trust dispositive provisions. To test the impact of the provisions, the attorney needs to think through how the assets in the trust will distribute income or assets to beneficiaries. Ideally, such cash flow projections should take into account the tax characteristics of all payments during the client's lifetime or after-death. Such detailed number crunching usually requires assistance from a wealth design consultant who knows how to modify trust terms, assets, interest rates, distribution rates, and other variables to achieve numerical income and inheritance targets provided by the client.

Sixth, checklists must detail next actions. Obviously, numerous tasks should come to light as the wealth counselor, wealth coach, wealth design consultant and other types of wealth advisers work with the lawyer to draft the trust. The wealth adviser and/or attorney should appoint a case manager and/or paralegal to track next actions. If using web-based project management software, planning team members can virtually look over the shoulder of each adviser 24/7 to confirm completion of each next action by the scheduled due date. When the mission and objectives of the teams are translated into concrete next actions, the drafting attorney can confidently spot and address any "devils in the details."

Communicating Trust Benefits

Whereas a revocable trust can often be drafted according to relatively simple and predictable checklists for a lawyer and paralegal, irrevocable trust drafting may involve hundreds of interrelated next actions involving appraisers, accountants, and up to a dozen different professionals. Drafting an advanced revocable trust might require only 30 hours of attorney and staff time at a weighted average cost of maybe $133/hour -- for a total cost of perhaps $4,000. An irrevocable trust, on the other hand, may involve several different attorneys and advisers who may invest more than 160 hours at an average rate of $160/hour or more. This can raise the cost to more than $25,000. This may seem expensive until we weigh the trust costs against the benefits.

The benefits of an irrevocable trust can include peace of mind, asset protection, and tremendous tax savings. If a client with $2 million of assets in his or her taxable estate moves these assets to an irrevocable trust, the tax savings may be $700,000 under the tax law in effect for 2011. Even if the client uses one of the more sophisticated trusts costing $25,000, the tax savings can be more than 40 times greater than the cost. Good attorneys will summarize qualitative benefits of using an irrevocable trust while also quantifying how the benefits should exceed the costs by a substantial amount.

Too many lawyers draft irrevocable trusts and give the client a fat stack of black and white pages without documenting details in the above six areas or without clearly communicating the benefits of the trust. This invariably creates stress and confusion. If the client and the client's other advisers cannot describe clearly how the trust document meets the client's need, or the client cannot easily appreciate how the trust benefits are greater than the costs, then the attorney must focus more on illustrating the trust features and benefits appropriately.

To test whether the client and advisers understand how the implemented trust should produce desired benefits, it is wise to "triangulate" with pictures, text, and numbers. When all people affected by the trust agree that the trust makes sense graphically, numerically, and textually, then the attorney and client can proceed confidently with implementing, funding, and maintaining the trust. The following paragraphs describe how a trust should be presented to clients or advisers who process information graphically, quantitatively, and/or verbally.

Illustration	Role	Triangulation Tools
Balance sheet	Wealth Adviser	Numbers
Vision Statement	Wealth Adviser	Text
Consent Grid	Wealth Adviser	Text
Cash Flows	Wealth Adviser	Numbers
Flow Charts	Lawyer	Pictures
Next Action List	Wealth Adviser	Text

First, flowcharts for the client are critically important because these graphics illustrate how assets will flow into or out of the trust to benefit the trust settler and/or beneficiaries. Moreover, bar chart graphics can illustrate how the proposed benefits compare to the current benefits. The benefits are typically illustrated on a bar chart with four or five bars. The bars may show a reduction in income tax, reduction in estate tax, reduction in GST or gift taxes, increased income to the family or increased inheritance for the family members.

Second, to illustrate the numbers on an irrevocable trust, the plan design experts should show the year-by-year cash flows from the trust. The chart should show the money that goes into the trust each year. The numerical illustration table should also show income, gifts, or inheritance amounts coming out of the trust each year. Ideally, the cash flows from the irrevocable trusts should be integrated with annual cash flows from other irrevocable trusts or revocable trusts. In this way it is possible to calculate the aggregate income going to the client every year or the aggregate inheritance going to the children each year. Perhaps the best way to ascertain the effectiveness of the design is by confirming that the client and the client's advisers are all comfortable with the bottom line cash flow and inheritance benefits illustrated with numbers.

Third, bullet points should summarize text in the trust document. Trust cash flow, tax and distribution numbers will only illustrate properly if somebody has thought through exactly what the distribution provisions are in the trust. Whereas many attorneys focus on the distribution of assets, the best attorneys will ask how and when income and principal from assets, as well as the management and control of assets, will pass into the trust and out to trust beneficiaries. After clarifying who will have what portion of the ownership, cash flow, management, and control under different circumstances, the attorney can then draft a document consistent with the client's vision and values.

Conclusion

The estate tax in 2011 may have top marginal rates as high as 60%. Each $1 million moved to an irrevocable trust could save $600,000 of taxes. The benefits of the trust can far out-weigh the costs -- even if advisers spend the extra billable hours to develop the balance sheet, vision statement, consent grid, cash flows, flowcharts, and next action lists described in this article. The client can have confidence that all six key dimensions have been analyzed correctly when the attorney summarizes the trust benefits with pictures, numbers, and text showing the projected distributions to trust beneficiaries. Clients should see a compelling value proposition as the attorney works with advisers to communicate how the quantitative and qualitative benefits of the trust far outweigh the costs.