Securing Your Family's Future Using Inheritance Trusts

PART 3: The Logistics of Inheritance Trusts

In parts 1 and 2 of this series, we described Inheritance Trusts and how they can achieve clients' desires to maintain their assets for as long as possible as a safety net protecting themselves and their loved ones from both anticipated and unforeseen threats and challenges. In this installment, we go over the mechanics of setting up and operating an Inheritance Trust.

Titling Trust Assets and Setting Up Trust Accounts

When an Inheritance Trust is established, its Trustee (and in particular, a Trustee who is also a beneficiary of the trust) will need to keep inherited assets (as well as assets acquired in the future using the proceeds of these inherited assets) segregated from his personal assets. He does so by the titling of trust property and by using a separate trust taxpayer identification number.

Title to all newly inherited trust assets (and the proceeds of these inherited assets) should be kept in the name of the Inheritance Trust at all times. We prefer the following format for titling assets in the name of an Inheritance Trust:

> "Gloria Sample Jones, Trustee of the Gloria Sample Jones Inheritance Trust under Article Twelve of the John Sample Living Trust dated December 24, 2008"

Obviously, each beneficiary Trustee would insert his or her name in this language and the particulars of the source document when titling inherited assets to his trust. However, to avoid future problems with banks and financial houses, it is important to use a title that references the document that states the authority for the trust, the trust administration provisions, as well as the source for Trustee powers and succession provisions.

Merging Separate Inheritance Trusts from Each Parent

Often, children of the same parents will technically receive an Inheritance Trust from each parent. To avoid having multiple trusts, the source document will generally have a merger clause allowing the Trustee to merge multiple trusts with the same beneficiaries and trust provisions. As such, the substantially identical trusts set up by each parent can be merged by having the Trustees sign what is known as a Trust Merger Agreement. Thus, two separate Inheritance Trusts (i.e., one received each parent) are consolidated into a single Inheritance Trust for the beneficiaries involved.

Utilizing the Assets of An Inheritance Trust

In order to provide the asset protection and tax benefits described in Part 2 of this series, there need to exist certain technical restrictions on beneficiary Trustee access to an Inheritance Trust's property. However, beneficiary Trustees need not feel particularly limited by these restrictions because these provisions are purposefully drafted to be as expansive as possible without causing tax effect. The beneficiary Trustee will generally have complete authority as to the investment of trust property and broad authority as to when to make distributions.

A Trustee of an Inheritance Trust may make distributions of trust property to trust beneficiaries (including himself) for their education, health, maintenance or support. These terms have very broad meanings as demonstrated below:

- Education
  Includes payments for tuition, fees, books, supplies, living expenses, travel and reasonable spending money related to private pre-school, kindergarten, elementary school, middle school, college preparatory high school, undergraduate college, graduate college, and vocational, professional, or other specialized training
- Health
  Includes payments for medical services, prescription/over-the-counter drugs, and/or medical equipment, and, in general, anything directly promotive of the good health of trust beneficiaries
- Maintenance or Support
  Includes payments to keep the beneficiaries living in the manner that is reasonable given the amount of funds which can be devoted to this purpose, i.e., anything reasonably required to maintain the beneficiary's lifestyle. (In addition, Trustees are often given the discretion when and whether to take the beneficiary's other resources into consideration in making such lifestyle maintenance distributions.)

The principal limitation here is that Inheritance Trust assets may not be used to benefit persons or entities other than those persons who are currently the beneficiaries designated by the Trustmaker.

Types of Property an Inheritance Trusts Can Own

In general and unless otherwise specified in the Trustmaker's instructions, Inheritance Trusts may own any type of property that is readily available to the public, such as: real estate, farming/ranching businesses, stocks, bonds, commodities, options, metals, partnership interests, limited liability company interests, and other types of closely-held business interests. The limitations here are that the Trustee is obligated to the beneficiaries to invest prudently and to avoid self-dealing.

Inheritance Trusts may also own life insurance or annuity products. However, you should consult with an estate planning attorney prior to purchasing a life insurance or annuity product with an Inheritance Trust. Notwithstanding trust provisions, if the Trustee of a trust owns life insurance on his own life, that life insurance can be made taxable as a part of his estate.

Other Ongoing Trustee Duties

In addition to the duties discussed above, Trustees of Inheritance Trusts need to remember that they now have fiduciary duties to others to be responsible for many of the same tasks they would have been doing if they owned the property in their own name (rather than as Trustee of the Inheritance Trust), such as:

- Insuring trust property against potential hazards/casualties;
- Keeping records of the trust's financial history; and
- Filing annual federal and state income tax returns for the trust on April 15th of every year.

It is important to note that Inheritance Trusts will each be separate income taxpayers and will require their own respective income tax returns. To this end, Trustees need to use separate federal tax identification numbers for their trusts. Because trusts pay federal income tax based on very compressed tax brackets (in 2017, a trust's undistributed income is taxed at 39.6% once that income totals only $12,500), Trustees will probably want to do some distribution planning to make sure that as much of this income as possible is taxed at lower rates available to trust beneficiaries.

Trusts currently written as a Maryland trust are also subject to Maryland income tax. However, beneficiary Trustees who reside outside of Maryland may change the taxing state if the trust is being administered outside of Maryland and was not created under the will of a Maryland resident. One of the first administrative activities a beneficiary Trustee might want to consider undertaking is an examination with a local accountant or attorney as to where it makes the most sense to have the trust taxed.

Finding Assistance

Much of this may seem new to you, but it is not "rocket science". We are in business to help our clients plan their Inheritance Trusts and to help with their implementation and administration. If you would like to speak with us about achieving your goals for the future, please give us a call at (410) 224-7800.