

Benefits of Establishing a Preservation of Assets (PAT) Trust For Certain Assets

What is a Preservation of Assets Trust?

A **Preservation of Assets Trust** may be used to keep a family business, ranch, farm, etc., intact for many generations without the estate tax bite forcing a sale of the property.



A **Preservation of Assets Trust** may also be used to establish trust fund for future generations to assist them in obtaining a college degree or as an emergency fund to provide security. By delaying time when estate taxes are imposed more assets are available to future generations. Also, with assets in trust, future generations will not lose their property to divorces, bankruptcies, lawsuits, etc.

A **Preservation of Assets Trust** will defer estate taxes. If you leave assets to your children who in turn leave them to their children, who in turn leave them to their children, etc., there is a "transfer tax" (estate tax) imposed each time the property is left to the next generation. With a PAT, the transfer tax is postponed until the assets are finally distributed to your distant descendants and only when those distant descendants die.



When to Use a Preservation of Assets Trust

A Preservation of Assets Trust is appropriate when you want to either (i) preserve an asset for the family, not just for one person, such as a family ranch, farm, business, vacation home, etc., or (ii) create an educational fund for present and future generations, minimize the tax collector's bite and maximize the fund for future generations. This way you create a fund for future family scholarships and/or student loans.

If you want assets set aside for particular individuals to own and manage for their own benefit and then pass it on to their descendants, then a Personal Adult Management Trust or Personal Adult Lifetime Trust is generally the more appropriate trust to use. Please see our brochure regarding the Personal Adult Management Trust for further information

Detriments of a Preservation of Assets Trust

- **Descendants Do Not Have Complete Control Over Assets.** Since the property is in a trust, the descendants cannot do what they wish with the assets. They are limited by the grantor's instructions and the fiduciary duty they owe to future generations..
- **Administrative Duties for Trust.** Since the assets are in an irrevocable trust, such a trust must file income tax returns each year, pay out all ordinary income to the beneficiaries (who pay income tax on it), and the trust itself will keep any capital gains and, as a taxpayer, pay capital gains tax.
- **Certain Entities Not Suitable for PAT.** At present "S" Corporation stock, because of restrictions on types of shareholders, cannot be among the assets put in the trust. Substantially any other asset can be placed in the trust.

Attached hereto is a detailed memorandum to the trustee giving detailed instructions providing a list of acceptable expenditures.

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**MEMORANDUM REGARDING PRESERVATION
OF ASSETS TRUSTS**

TO: ESTATE PLANNING CLIENTS

FROM: JAMES G. KNOLLMILLER

CAUTION PLEASE BE ADVISED

This memorandum has been prepared to provide general educational information on the stated subject matter. It should not be interpreted as providing specific legal advice or response to any individual questions or issues you may have. Application of the ideas and concepts presented should only be undertaken after you consult with your legal counsel and obtain their advice as it pertains to your individual situation.

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This memorandum may serve as a guide and instruction to the future beneficiaries and trustees regarding the reasons why a Preservation of Assets Trust (hereafter referred to as PAT Trust) has been chosen to administer the included assets rather than making an outright bequest of these assets to you. First, some background information so that you are better informed as to why such trusts are advantageous to you.

In planning an individual's estate most estate planners recognize that there are really two tax systems, one for the informed and one for the uninformed. This same rule applies for those who wish to use credit protection strategies as compared to those who do not. There are significant tax and asset protection benefits that are derived through a well-conceived family estate plan that are not found in using unplanned arrangements. The PAT Trust is one of these planned structures to help preserve assets and save taxes. It is created for the benefit of the descendants of the grantors and provides protection of assets from the claims of creditors and payment of future estate taxes on your inheritance.

Size of Estate Considerations

The general size of the estate or portion of property going into a PAT will determine whether the normal trust or the generation-skipping tax (GST) trust needs to be selected. Because of the complexity of GST provisions the fees for drafting such trusts are more if the estate is larger. ***NOTE: For the purposes of determining size of estate, include life insurance proceeds and future potential growth in value.***

- (1) For single persons or couples who have estates less than \$2,000,000 the normal PAT format should suffice.
- (2) For single persons who have estates over \$3,000,000 consideration should be given to the larger estate format with GST provisions.
- (3) For couples who have estates in excess of \$6,000,000 the larger estate format with GST provisions **must** be used.

Many people desire to set up a trust for the benefit of the family and all future generations so that the trust goes on forever. Under trust law this generally cannot be done, since the "Rule Against Perpetuities" says no, and in those jurisdictions permitting unlimited life to trusts it is likely that the Internal Revenue Service will try to argue no. There is proposed federal regulations that would limit the trust to a 90 year "life." This rule simply stated means a trust must cease twenty-one years after the death of the last person from a named group of people alive when the trust was established. However, by careful selection of this group, a PAT Trust can be established that will last upwards of one hundred years before the assets are again subject to estate taxes. Likewise by choice of what state law will govern the trusts and the "situs" (place where the trust is a "resident") can offer the opportunity for a trust that can exist for periods of time in excess of the common law twenty-one (21) years plus lives in being. The following paragraphs will explain in more detail the reasons why such a trust may be established and gives a more complete explanation to each question. The format selected will depend upon an estimate of the size of the trust when it will be established at the death of the grantor (or the grantor and spouse).

Example of This Program

Client and Spouse, age 80 and 78, have three children: Child A, age 60; Child B, age 58, and Child C, age 56. They also have eight grandchildren ages 16 to 35, and six great grandchildren ages 0 to 12.

A PAT Trust is provided for in their Revocable Living Trust saying that the trust will be in existence until twenty-one years after the death of all of the descendants of grantor and spouse who are **living** at the time the trust is funded. Now when such trust is funded and established (either at death of grantor or spouse), even if two more great grandchildren are born in the meantime (if born after revocable living trust established but **before** funding; once trust is established and funded then only lives "in being" at that date can be used to measure length of duration of trust), these two great grandchildren's lives will also be included as part of the measuring criteria for when the trust must finally distribute assets. Such a trust can also provide benefits for future great grandchildren born later but the "life" of the trust will be fixed.

Husband and wife have \$800,000 in assets and the following family at death of husband:

Child A	Age 60
Child B	Age 58
Child C	Age 56
8 Grandchildren	Ages 16 to 35
6 Great Grandchildren	Ages 0 to 12

Between the time of the husband's death and the wife's death two more great grandchildren are born. The trust established with the husband's \$400,000 share of the estate at his death would elect to use part of his GST exemption so that the trust would be exempt from such tax upon final distribution. The trust established at the wife's subsequent death with her share of the estate would make similar elections for GST purposes. Both of these trusts would be established to stay in existence for the longest possible time, namely:

The husband's trust would finally distribute the principal twenty-one years after the death of the three children, eight grandchildren and 6 great grandchildren, whereas the wife's trust would add the two new great grandchildren born after the husband's death to the list of lives determining when the trust would terminate. Both trusts would provide for income distribution to present and future born descendants, but would accumulate principal.

How long could such a trust be in existence? If the last person to die from the group lives eighty years, add twenty-one and final distribution would be 101 years in the future. In that time if the \$400,000 of capital grew at a net annual rate of 3%, the trust would have about \$8,000,000 in assets; at 8% it becomes in excess of \$950,000,000 (yes, that is correct) to go to lineal descendants **free** of GST and estate taxes. Furthermore, during this 101 year period, the trust assets would not be subject to estate taxes at any of the beneficiaries' death. The beneficiaries would only be subject to income taxes on the income distributed to them during this time period. Could the trust stay in existence for a longer period? Yes, under certain state laws trusts can be established that will be in existence for hundreds of years or even forever. However, before one embarks upon establishing such a trust one should discuss the full long term ramifications of such a decision.

Benefits of a PAT Trust

1. **Defer Estate Taxes.** We are all aware of the advantages of reducing, avoiding, or deferring taxes. Generally most of us are concerned with income taxes, but in order to build up wealth for long periods of time, one must also consider the imposition of estate taxes. Currently the estate tax is 35% of all assets over the exemption (\$5,120,000 in 2012 but scheduled to decrease to \$1,000,000 in 2013) and reach a high of 55% (and 60% in very large estates). In the normal method of transferring wealth from parent to child, child to next generation, and so forth the Internal Revenue Service gets an opportunity to “bite the apple” each time there is a transfer. It can be clearly seen at these tax rates that they take a very big “bite” out each time. Considering that these generations fall somewhere around the 30-year mark, you can see that it is very simple to compare a sum of money that goes through three generations with a tax bite each time compared to the same sum that does not get a bite taken out. Even without the growth in value through interest earned, the net difference is substantial.

Comparison of estate tax bite of 50% for three generations to no estate tax bite:

	<u>Tax Bite</u>	<u>No Tax Bite</u>
Initial fund	\$100,000	\$100,000
1 st generation bite	<u>(50,000)</u>	<u>-0-</u>
Left for 2 nd generation	50,000	100,000
2 nd generation bite	<u>(25,000)</u>	<u>-0-</u>
Left for 3 rd generation	25,000	100,000
3 rd generation bite	<u>(12,500)</u>	<u>-0-</u>
Remainder	\$12,500	\$100,000

The above simple comparison illustrates that, even without any growth in the value of the assets, the big winner after a few generations is the government. If you throw in a growth factor, then the difference becomes even more pronounced. Without going into the mathematical details, if a modest interest rate is selected (6%), by the time the third bite is taken, the difference will amount to more than 30 times greater with the no tax bite trust vs. the tax bite each time.

2. **Protect Assets and Keep in Family.** Using the preceding example, it can be seen that a family business, ranch, farm, etc., can be kept intact for many generations without the estate tax bite forcing a sale of the property. The trust can also be used to provide an educational fund for future generations and assure that funds are made available for the education of all of your descendants. It can be set up to grant scholarships and/or student loans, or a combination thereof.

Asset protection and liability planning has always been a consideration, but given the more litigious nature of our society coupled with the proliferation of divorces, creditor protection is often a very motivating factor. Certainly no one wants to pay any more taxes than necessary, and judgment credit problems and divorce settlements are also situations for which one does not want to pay excessive amounts. The PAT Trust offers a significant degree of protection in this area. When an irrevocable trust is established by someone other than the party who is the beneficiary, it provides what most planners consider the ultimate in creditor protection. The asset protection maxim goes, "If you don't own it, nobody can take it away from you."

3. **Provide Security for Future Generations.** By delaying time when estate taxes are imposed more assets are available to future generations. Also, with assets in trust, future generations will not lose their property to divorces, bankruptcies, lawsuits, etc. The general rule in trusts are that unless trust property is distributed a beneficiary or subject to control by the beneficiary, it is protected from the beneficiary's creditors. There have been inroads in this area by legislation and cases, however, the PAT Trust offers the most protection of any legal devices available.

Detriments of PAT Trust

1. **Descendants Do Not Have Complete Control Over Assets.** Since the property is in a trust, the descendants cannot do what they wish with the assets. They are limited by the grantor's instructions and the fiduciary duty they owe to future generations. (This may be a benefit to some people to prevent a spendthrift child from consuming the inheritance). The PAT will "tie" up the assets for a long time; however, there are provisions for principal distributions for "ascertainable standard" (health, education, welfare, etc.) needs.

2. **Administrative Duties for Trust.** Since the assets are in an irrevocable trust, such a trust must file income tax returns each year, pay out all ordinary income to the beneficiaries (who pay income tax on it), and the trust itself will keep any capital gains and, as a taxpayer, pay capital gains tax. (There may be instances when such taxes paid by the trust could be more than if an individual beneficiary paid the tax.)

3. **Certain Entities Not Suitable for PAT.** At present S Corporation stock, because of restrictions on types of shareholders, cannot be among the assets put in the trust. Substantially any other asset can be placed in the trust.

Managing the Pat Trust

Management of this trust is not significantly different than managing your own assets. The trustee is responsible for managing all of the trust assets. It will be necessary to obtain a separate federal tax identification number for the trust and to file income tax returns each year. Under present tax laws, the trust itself would be subject to income taxes. The trust itself will retain any capital gains and pay income taxes on the capital gains retained. This is of benefit to you because those gains will not be part of your estate but will be in the trust and can be utilized to generate additional income for you if you so desire and pass free of estate tax your heirs.

The general trustee powers of the revocable living trust will show that there are certain limitations on investments. In addition, state laws generally provide what is called "prudent man" rules for investments. You must be careful to document all investments in the trust name and keep records to show that the trust owns the actual assets. In that respect, the assets should be titled in the name of the trust (i.e., DOE PRESERVATION OF ASSETS TRUST under the JOHN & JANE DOE TRUST U/A/D _____, 20____).

It will also be important for you to keep accounting records detailing the income earned each year, the distribution to yourself of the income as the beneficiary, and the retention of principal. Whenever there is a principal distribution made as a discretionary distribution, it is suggested that you maintain records stating why the distribution was needed and retain supporting documents. These records should be maintained essentially forever, as this trust will be in existence for your entire lifetime and beyond, perhaps even beyond the lifetimes of your children and grandchildren. These records will be important to show tax authorities that the trust in fact was managed as described under the trust agreement and should not be included in your estate or the estates of your children or grandchildren. Some people even maintain a record book similar to that maintained by corporations in their minute books. The better the records are kept the better the case will be for you and your family if creditors attempt to get at the trust assets or the estate tax collector tries to prematurely include the trust in your estate.

Summary

The above is a brief summary of the administration and management of the trust. If you have questions please contact a competent tax advisor who can advise you as to the current tax laws applying to these types of entities, since tax laws and other rules will change from the time the trust was drafted until the date the trust becomes effective.

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PLEASE NOTE: Based on IRS Circular 230, the Internal Revenue Service may consider this memorandum as a "covered opinion." Therefore, we make the following disclaimer regarding its usage. Any tax advice we provide in this communication is not intended or written to be used, and cannot be used by you or any other person or entity for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or any applicable state or local law. It is provided for information and guidance only. You need to consult with your tax advisor regarding any tax issues that arise in the funding and operation of your trust.

IRS Circular 230 Disclosure

Pursuant to recently enacted U.S. Treasury Department Regulations and to ensure compliance with the requirements imposed upon us by the United States Internal Revenue Service, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including attachments and enclosures, is not intended or written to be used, and may not be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

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