ANATOMY OF ESTATE PLANNING DOCUMENTS – Trusts

A Non-Comprehensive Collection of Things to Think About While Planning, Drafting, and Administering a Long Term Trust

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William A. Peithmann
The Peithmann Law Office
Mahomet, Illinois

ABOUT THE AUTHOR

William A. Peithmann attended the University of Illinois College of Law before receiving his law degree from the University of Denver in 1978. A frequent contributor to legal publications on estate planning matters and lecturer at various tax and estate planning institutes, Mr. Peithmann is a past Chair of the Illinois State Bar Association's Trusts & Estates Section, a former member of the ISBA's Board of Governors and Director of the Illinois Bar Foundation, a Fellow of the American College of Trust and Estate Counsel, and is listed in *The Best Lawyers in America* in both the "Trusts and Estates" and "Tax" categories. In 2009 he was cited by *Leading Lawyers Magazine – Consumer Edition* as one of the "Top Ten Downstate" (non-Chicago) Illinois lawyers in his fields. Mr. Peithmann strictly limits his practice to select tax, wealth management, and related matters, with emphasis on multi-generation family farm operations, with the occasional back alley brawl to keep his game up.

ABOUT THESE MATERIALS

The following materials represent excerpts from previous projects and the author's sometimes futile attempts to find solutions to some particularly troublesome problems. Much has been gleaned from other experts who have given generously to the profession and have straightened his often unsteady thinking. While every effort has been made to assure the reasonable accuracy of the analysis and suggestions included in these materials, the author cannot assume responsibility for the contents beyond their use as a general teaching and reference guide. Any person engaged in the tax, business or estate planning process, and in particular one whose efforts involve the practical application of strategies pertaining to marital deduction planning, the generation skipping transfer of property, fiduciary duties, or the prospective insulation of property from the claims of creditors must independently verify the accuracy and applicability of the law to each particular circumstance, and in turn satisfy himself or herself as to consequences that may occur.

Mahomet, Illinois - September, 2011

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By: William A. Peithmann
The Peithmann Law Office
Farmer City, Illinois

I. INTRODUCTION

A trust is an equitable title or interest in property held by the legal owner for the benefit of another person; a separate, formal, legal body created to hold assets for the benefit of others. A creation of the English common law and the equity jurisdiction of the chancery courts, trusts are as elastic as the imagination, and for making dispositions of property there is probably no tool more versatile. A trust can be created for any purpose that is not illegal or contrary to public policy. The duties of the trustee are what the creator of the trust chooses to impose, and the interests of the beneficiaries are such as the creator may choose to confer. Within the broad outlines of fiduciary responsibility and accountable benefit trusts are remarkably nimble and fit as implements of wealth management and transfer; to effect family settlements, to separate the benefits of ownership from the burdens and discretions of management, and to create any number of different forms of concurrent and consecutive beneficial interests, with and without specific regard to the myriad of income and transfer tax applications.

Such a broad and elusive topic necessarily reduces the scope of what can be approached by this brief treatment, and there will be little reference to the more narrowly defined special purpose trust forms that deserve and have received specific treatment elsewhere. Instead, this presentation merely highlights a few problems and opportunities, and techniques for planning, drafting and administering estate planning trusts directed to the efficient disposition of property after death. It contemplates most of the usual property transfer, tax, and administrative issues, loosely collected around certain topics or themes, and is intended more to raise issues to consciousness than to provide canned instructions and answers. Except for a few technical rules, very little of what is discussed here is fixed and final, because fixed and final answers to planning and drafting generally don't exist, and unacquainted reliance on unfamiliar forms is the malpractice equivalent of driving one's car blindfolded. The main thrust, rather, is to introduce the newcomer to a bit of what to look out for, and perhaps remind the experienced practitioner either of some one thing or another that he/she may have forgotten for the moment; or, better yet, to confirm for comfort something that was already well in hand.

II. SELECT GIFT, ESTATE, AND GENERATION SKIPPING TRANSFER TAX CONSIDERATIONS

No estate planning trust can be discussed without passing reference to the federal and state transfer tax context:

A. The Unified Transfer Tax System

Since 1977, the federal gift and estate tax systems[1] have been combined to reduce the differences between life time transfers and the transfer of property at death. This approach was disrupted in 2010 as the final phases of the 2001[2] tax act took effect, all in anticipation of sunsetting *in toto* on December 31, 2010, and then were restored at almost the last minute by the *2010* tax act[3]:

1. All taxable lifetime gifts (gifts other than to spouses, charities, or in excess of annual gift tax exclusions) <u>and</u> any assets remaining in the individual's estate at death, are aggregated and subjected to the unified tax rate schedule with a single unified lifetime tax credit

    a. Unified credit is a *credit* against the calculated tax due, *not* a deduction to compute the amount subject to tax. All or part of the tax credit is first applied to offset gift tax on lifetime transfers; what's left applies against estate tax due on transfers at death

    b. Effect of unified system is to pile the value of each current set of gifts onto the value of all prior taxable transfers made at any time. Credit is

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1 Internal Revenue Code Chapters 12 (Sections 2501 to 2524) and 11 (Sections 2001 to 2210), respectively.

2 The "Economic Growth and Tax Relief Reconciliation Act" of 2001 ("EGTRRA")

3 The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This law sunsets after 2012. Without further legislation, everything reverts to pre- EGTRRA standards on January 1, 2013.

then allowed against the total tax due according to the amount of unified tax credit available during the most recent year of transfer (or death) in order to calculate the tax that must be paid on that most recent transfer. Makes the estate tax computation at death fully derivative from all prior gift tax computations.

c. Amount of unified credit thus defines "the applicable exclusion amount"[4], or the value that can pass free from federal transfer tax.

(1) 2010 Act complicates this notion with new portability function of the deceased spouse's unused exclusion amount ("DSUEA")

(2) Redefines "applicable exclusion amount" with new "basic exclusion amount" of $5,000,000, for everyone; plus, for surviving spouses only, the unused exclusion amount ("DSUEA") is added on[5]

2. **Essential concept**: Once the transferred property has been subjected to this gift/estate tax equation it will not be subject to transfer tax again unless or until:

a. It has vested (or deemed to have vested, as with a general power of appointment[6]) in another owner; and,

b. That new owner transfers the property to or for the benefit of someone else.

3. *Until both events occur* the property is "sheltered" by the tax payments/tax credits of the last- taxed transferor. This ability to "shelter" property, by making it available in trust for the tax free use by others defines the "credit shelter trust" – critical for crafting tax efficient estate plans.

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[4] Code Section 2010(c)

[5] Section 303(a) of the 2010 Act amended Code Sections 2010(c)(2) - (6) and 2505(a). The basic unified credit for 2011 is $1,730,800, equivalent to $5,000,000.00. Note that the DSUEA does <u>not</u> include unused GST exemption

[6] Code Sections 2041 and 2514.

B. The Unlimited Marital Deduction

Since 1981, federal transfer tax law treats husbands and wives as one economic unit. Code Sections 2056 and 2523

1. Presumes no tax need be imposed upon gifts/ bequests between spouses. First spouse may leave unlimited amount to surviving spouse. So long as technical requirements for marital deduction are observed, there will be no tax assessed at first spouse's death.

    a. But, marital property not consumed during the survivor's lifetime will be subject to tax calculus upon the second spouse's death

    b. Thus "deduction" is misnomer. Best considered a tax "deferral" until both members of the marital team are gone. (Contrasts with the unified credit/applicable exclusion amount that represents a pure reduction of the combined tax burden)

2. Marital deduction applies to outright transfers, including joint tenancies, POD/TOD, also gifts in qualifying trusts, including estate trusts and general power of appointment trusts under Code Section 2056(b)(5)

3. Always popular/increasingly essential (see Illinois estate tax discussion below) is qualified terminable interest property ("QTIP") marital trust under Code Sections 2056(b)(7) (estate tax) and 2523(f)(for gift tax). Core requirements include:

    a. Trust property must have passed from the decedent/donor spouse

    b. Surviving spouse must:

        (1) Be a U.S. citizen;

        (2) Receive all of the income from the property at least annually; and,

        (3) No person may have the power to appoint any of the trust property to anyone other than the surviving spouse during his or

her lifetime; and

c. An election to qualify *any part or all* of the transfer must be made on a timely filed gift or estate tax return[7]

d. Note flexibility and utility:

(1) Election to treat QTIP as marital deduction property is *optional*; other marital deduction plans are automatic and risk over-funding, but a QTIP qualifying trust can be used to fund the credit shelter trust so long as the QTIP election is not made

(2) Formula election allows personal representative to"zero out" the taxable estate by electing only so much marital deduction as actually needed and leaving the balance to be sheltered by the available unified credit

(3) “Reverse” QTIP election is available to avoid GST problems with prior marital deductions, and not available for other marital deduction methods[8]

C. The Generation Skipping Transfer Tax

The basic gift/estate tax scheme taxes the *transfer* of property but not its use. Once launched and taxed, property had traditionally been left free from further tax until it vested and was transferred again. Mere termination of each intervening limited interest was effectively ignored.[9]

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[7] Treasury Reg. 20.2056(b)-7(b)(2). Any partial election must be on a fractional basis, which “may be defined by formula”. The resulting division of the trust must also be on fractional basis, but “the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.”20.2056(b)-7(b)(2)(ii)

[8] Code Section 2652(a)(3)

[9] Thus, an owner could devise an estate plan whereby first a spouse, then children, then grandchildren and great grandchildren, each in succession or concurrently, could use the trust estate as needed, yet none of these successors would have a taxable "interest" in the property until the trust terminated and the property finally vested outright. For a long time even the degree of a beneficiary's dominion and control was irrelevant. The U.S. Supreme Court has ruled conclusively that even a general power of appointment is not an "interest" in property taxable in a decedent's estate. *U.S. v. Field*, 255 U.S. 257, 41 S. Ct. 256 (1921); *Helvering v. Safe Deposit & Trust Co.*, 316 U.S. 56, 62 S. Ct. 925 (1942). Following these decisions Congress overhauled the tax treatment of powers of appointment in the Revenue Act of 1942, which in turn

1. Since 1986 Congress has concluded that these suspended untaxed transfers were unfair, and that s*ome* tax should be imposed on the property at least once per generation. Result is Chapter 13 of the Internal Revenue Code (Sections 2001-2210)

2. Chapter 13 GST theory is deceivingly simple:

> **<u>Except as exempted</u>, property not subject to either gift or estate tax in each successive generation must face its own GST tax at top estate tax rate**

3. Much more complicated in practice. Built on top of existing gift and estate tax system, but adds new and confusing concepts:

   a. **"Generation-skipping transfer"**, defined as: (i) a transfer of property; (ii) that is subject to gift or estate tax at the time; (iii) to or for the benefit of someone who is (or is deemed to be) two or more generations younger than the person charged with the tax; and (iv) without a second gift or estate tax being assessed on the property along the way. Can be a **"direct skip"**, a **"taxable distribution"**, or a **"taxable termination"**

   b. GST tax is imposed at a flat **"applicable rate"** to the **"taxable amount"** of the generation-skipping transfer. Applicable rate is maximum federal estate tax rate (now, 35%) unless some part of the transferor's **"GST exemption"** is involved, in which case an **"inclusion ratio"** is calculated to dilute the tax rate percentage

   c. Key parties include "**the Transferor"**[10]**; "Skip person",**[11] and the

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was fine tuned by the Power of Appointment Act of 1951. This legislation is the source of the legislative fiction, embodied by current Code Sections 2514 and 2041, that certain powers over property -- those which fall into the tortured definition of a tax "general power of appointment" -- are to be construed as ownership, and the property subject to such general powers taxed accordingly.

10 In GST jargon the "Transferor" is a technical term that applies to: (i) the person charged with transmitting the property, directly or indirectly; (ii) in a way that will (or might) avoid gift/estate tax in the next generation. This generally will include: (a) the owner of the property, whether as decedent or the inter vivos donor; (b) the surviving spouse beneficiary of a marital deduction trust taxable in the surviving spouse's estate (although there is a huge exception for Section 2056(b)(7) QTIP trusts: or (c)any one burdened with a taxable general power of appointment over the property. All GST analysis returns,

"Non-skip person"[12]

4. **"GST exemption"** is the key. Code Section 2631(a) allows every individual a "unified" lifetime exemption from GST tax. For 2011 and 2012, the GST exemption tracks the basic/applicable exclusion amount of $5,000,000.00[13], and may be allocated to any property with respect to which he/she is the "Transferor"[14]

   a. Once allocated, exemption value is elastic, matching all increases or decreases in the trust value, much the same as a single generation credit shelter trust works. A wholly exempt trust (one with an "inclusion ratio" of zero) will never be exposed to GST tax, no matter how large it grows before termination/distribution

   b. Exemption is indefinite so long as the trust property maintains its tax nexus with the original Transferor. Principle is same as the "credit shelter" trust; however –

   c. If exempt trust property is somehow taxed to a beneficiary, as will occur with a general power of appointment, that just-taxed beneficiary will step into the box as the new Transferor and the prior exemption will vanish. That is <u>not</u> a good thing.

The GST tax regime is comprehensive, complicated, and riddled with hazards. Unintended GST events can result from any number of traditional estate planning techniques,

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eventually, to the question: "Who is (or who will be) the Transferor?" The answer will almost always be found by focussing on where the gift and estate tax burden last fell, or will fall.

[11] Which is either a natural person or a trust. Code Section 2613(a)(1); Treas. Reg. 26.2612-1(d).

[12] Defined by default as anyone/thing who is not a Skip Person. Code Section 2613(b).

[13] The first time that the gift and estate tax applicable exclusion amount, and the GST exemption amount, have been unified. Avoids a lot of confusion and drafting acrobatics.

[14] The "Applicable Rate", the "Inclusion Ratio", and the "Applicable Fraction" are all defined by the amount of allocated GST exemption. An Inclusion Ratio of "0" means a tax rate of "0" on all subsequent Taxable Terminations and Taxable Distributions regardless of the property value distributed. Thus, when the value of property passing in trust exceeds the amount of available exemption, it is best to plan for two trusts -- one with an Inclusion Ratio of "0", the other with an Inclusion Ratio of "1" -- than to have a single trust with an Inclusion Ratio somewhere in between.

triggering hefty unexpected tax. Any attorney preparing a multi-generation trust has no choice but to grasp the law's fundamentals or refer the project to someone who does.

D. Powers of Appointment

A power of appointment is the power to direct the disposition or use of property that belongs to someone else. They are incredibly flexible and efficient for multi-generational planning and administration, but have powerful tax implications under Code Sections 2041 and 2518.

1. Tax power of appointment rules flow from a legislative fiction that certain general powers of appointment shall be construed as if the power holder actually owned the subject property.

2. Possession, exercise, release or the mere lapse of a general power can trigger gift and estate tax, and seriously disrupt GST planning.

3. Safe harbor from general power treatment lies in the "**ascertainable standard"**, which limits the power to distribute to matters of "health, education, support, or maintenance"[15].

4. The ascertainable standard exception prevents the subject property from being included in the beneficiary holder's estate yet places little practical restraint on the beneficiary's access. There is sound reason for including the ascertainable standard restraint on <u>every</u> distributive power held by an interested trustee unless it is intended that the property fall within the holder's tax orbit.[16] The standard places little practical restraint on a beneficiary's access, and can avoid ugly surprises under other tax provisions as well[17]

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15 Treas. Reg. §25.2514-1(c)(2) and 20.2041-1(c)(2) include the following specific qualifiers: "support"; "support in reasonable comfort"; "support in his accustomed manner of living"; "education, including college and professional education"; "health"; "medical, dental, hospital, and nursing expenses, and expenses of invalidism". These standards are in fact more generous and less restrictive than may first appear. The terms "support" and "maintenance" are not limited to the bare necessities of life, and it is immaterial whether the beneficiary is required to exhaust other income before the power can be exercised.

16 As will be the case with "non-exempt" generation-skipping trusts.

17 For example, if an interested trustee distributes trust corpus to another beneficiary under a fiduciary power, he/she will be making a taxable gift governed not only by Section 2514 but by Section 2511 as well. Treasury Regulation 25.2511-1(g)(2). It is your author's default practice to employ ascer-

E. Section 2032A Special Use Valuation for Farm Estate Planning

Internal Revenue Code Section 2032A offers a vital estate tax break for active farm families. The effect of Section 2032A is to reduce the estate tax value of qualified farm land from its full fair market value to its "special use value" by using a formula that combines property taxes, prevailing fair market cash rents, and the effective rate for new Federal Farm Credit System loans as published by the Internal Revenue Service.[18]

1. Qualifying standards are strict:

    a. Decedent must have been a U.S. citizen

    b. Subject land must be located in the United States

    c. Family must have used that exact land (not replacement §1031 land) for farming (which is a "qualified use") for five out of the last eight years before death, or retirement, or disability

    d. Decedent, or a **"member of the family"**[19] must have **"materially participated"** in the farming for a period of five years out of eight before death [20]

    e. Total farm assets (real or personal property used in farming, at full fair market value less debts and mortgages) must constitute at least 50% of the decedent's total gross estate for federal estate tax purposes

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tainable standards for all purposes *unless it is intended* to create general power treatment.

18 Treas. Reg. § 20.2032A-4; *See* Rev. Rul. 2011-17 for 2010 and 2011 rates.

19 Code Section 2032A(e)(2). A member of the family includes includes: ancestors; spouses; lineal descendants of the decedent, his or her spouse, or the decedent's parent (thus, nephews and nieces are qualified heirs, but cousins are not!); a spouse of any lineal descendant of the decedent, his or her spouse, or the decedent's parent; a trust, provided that only qualified heirs receive the present interest in the trust

20 "Material Participation" is defined by cross reference to the net earnings tests applicable for self employment tax purposes; *See* Code Sections 2032A(e)(6) and 1042(a)(1); Treas. Reg. § 20.2032A-3(e)(2).

f. Farm real estate (at full fair market value less secured debt) must constitute at least 25% of the decedent's total gross estate for federal estate tax purposes

g. The real estate for which Section 2032A value is elected must pass from the decedent to a qualified heir; i.e., a "member of the family"

h Qualified heirs must continue to operate the property for a **qualified use** -- production risk farming -- for a period of ten years following the decedent's death

i. The 2032A valuation must be properly elected on the estate tax Form 706, Schedule A-1

j. All "qualified heirs" who receive any present or future interest in the property valued under Section 2032A must sign an agreement agreeing to the 2032A terms, and accepting personal liability for recapture tax if qualified use fails during the ten year period following death

2. If ALL of the foregoing requirements can be satisfied, then personal representative may report the value of the subject land for federal estate tax purposes according to a special formula based upon the fraction where:

a. Numerator is five year average annual gross cash rental for comparable local properties, LESS five year average annual real estate taxes on the comparable properties

b. Denominator is the average annual effective interest rate charged on new Federal Farm Credit System loans

c. Section 2032A is *not* a tax deduction, or an exclusion of fair market value from the taxable estate; instead, special use valuation method is based upon Congress' almost unique tax policy decision, codified by this fictional formula, that qualifying farm land is more fairly valued in accordance with the predictable rate of return that similarly valued assets could earn if they were not dedicated to continued family farm use

3. Maximum reduction for 2011 is $1,020,000, but indexed annually for inflation.

4. 2032A values also apply to GST and Illinois estate tax calculations, multiplying its value when suitable.

Top central Illinois farm land is now selling near $10,000.00/acre, and in some cases for more. But using the 2032A formula, and assuming: (i) five year rents of $200, $225, $250, $300, and $350 (averages $265/acre); (ii) five year average real estate taxes of $20.00/acre, meaning; (iii) a $245.00 net numerator; and a denominator of the 2010 rate of 6.41% produces a Section 2032A special use value of $3,822.00. That is a 77.88% reduction in reportable value. Note that the lower the interest rate denominator, the less benefit afforded by the election. Using the 2011 interest rate of 6.12% produces a Section 2032A value of $4,003.00.

F. The Illinois Estate Tax

Effective January 1, 2011, Illinois re-instated its estate tax[21]

1. Allows maximum state death tax "exclusion amount of only $2,000,000."[22]

2. Applies to every Illinois citizen and to non-citizens who own "property" – in most cases, *real* property – situated in Illinois.[23]

3. Substantially similar to the 2009 law; creates havoc with a lot of existing A-B/credit shelter estate plans: An existing credit shelter lead formula trust, geared to shelter the maximum federal basic exemption amount of $5,000,000.00, with sprinkle family benefits, will trigger Illinois tax of $352,158.00.[24]

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[21] Illinois Public Act 096-1496, the "Taxpayer Accountability and Budget Stabilization Act", amending the Illinois Estate and Generation Skipping Transfer Tax Act [35 ILCS 405/1 - 18].

[22] 35 ILCS 405/2(b)

[23] 35 ILCS 405/3(a)

[24]

The tax calculation depends on an interrelated formula that the Attorney General has simplified with its on-line calculator. For that tool and other important compliance information regarding the Illinois Form 700 go to www.illinoisattorneygeneral.gov/publications/calculator

4. However, Illinois also restored its own version of the QTIP rule from 2009 as well (35 ILCS 405/2(b-1):

> **(b-1) The person required to file the Illinois return may elect on a timely filed Illinois return a marital deduction for qualified terminable interest property under Section 2056(b)(7) of the Internal Revenue Code for purposes of the Illinois estate tax that is separate and independent of any qualified terminable interest property election for federal estate tax purposes. For purposes of the Illinois estate tax, the inclusion of property in the gross estate of a surviving spouse is the same as under Section 2044 of the Internal Revenue Code. In the case of any trust for which a State or federal qualified terminable interest property election is made, the trustee may not retain non-income producing assets for more than a reasonable amount of time without the consent of the surviving spouse.**

5. Effect is to lead away from two-trust plans to *three*-trust plans:

    a. Trust No. 1: The first $ 2,000,000

        (1) May be *either* traditional family/sprinkle trust or non-elected marital QTIP

        (2) Trust is credit sheltered for both federal and Illinois.

        (3) GST exempt; limited powers of appointment appropriate

    b. Trust No. 2: The next $ 3,000,000.

        (1) QTIP qualified

        (2) No election for federal, but elected for Illinois.

        (3) Trust is credit sheltered for federal; marital deduction for Illinois

        (4) GST exempt; limited powers of appointment appropriate

    c. Trust No. 3: The balance

        (1) QTIP qualified

(2) Elected for both federal and Illinois

(3) Marital deduction for both federal and Illinois

(4) GST non-exempt; limited *and general* testamentary powers of appointment appropriate[25]

6. *Note that Illinois does not have a gift tax.* Distinguishes Illinois planning from federal planning, and in some cases encourages inter vivos gifts

G. Tax Apportionment

Various property interests or transfers of property trigger transfer tax. Some of these transfers pass under the will; some by living trust; some by contract, beneficiary designation or survivorship (retirement plans and life insurance); some by powers of appointment, or elections, or takers in default. Where taxes must necessarily be paid, which group of interests should bear which burden?

1. Especially important where there are different classes of takers, such as mixed families, second/third spouses, charities. Important to divine grantor's preferences and not rely on "boiler plate" forms

2. Illinois rule based on common law and federal tax rights of reimbursement; there is no Illinois tax apportionment statute. Generally follows two rules: (i) burden on the residue for probate assets; and, (ii) equitable apportionment between probate and non-probate assets. *See generally*, *In Re Estate of Maddux,* 93 Ill. App. 3d 435, 417 N.E.2d 266 (5th. Dist. - 1981) and *In Re Estate of Materhofer,* 328 Ill. App. 3d 987, 767 N.E.2d 850 (3d. Dist. - 2002)

3. No federal tax law for apportionment; generally defers to state law. However, Internal Revenue Code affords various rights of reimbursement for federal transfer tax paid by the personal representative, including:

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[25] The restriction against a power to appoint the property to someone other than the surviving spouse does "not apply to a power exercisable only <u>at or after the death</u> of the surviving spouse." Code Section 2056(b)(7)(B)(ii).

a. Code Section 2206 – allows Executor to collect the pro rata estate tax attributable to life insurance; can be waived in the Will

b. Code Section 2207 - allows the Executor to collect the pro rata estate tax attributable to general power of appointment property over which the decedent held a general power of appointment; surviving spouse generally exempt (per marital deduction rules), and otherwise can be waived in the Will

c. Code Section 2207A - allows the Executor to collect reimbursement against QTIP property. But note differences:

   (1) The reimbursement is for the incremental estate tax attributable to the QTIP trust, not the pro rata tax that is reimbursable for the insurance and general power of appointment trusts;

   (2) Waiver of reimbursement may be by Will *and* trust, unlike the waiver for life insurance and general power of appointment trusts

   (3) Must be specifically stated; general waiver of reimbursement is insufficient

d. Code Section 2207B - allows the Executor to collect the pro rata estate tax attributable to transfers with retained interests, such as GRATS or GRUTS. Does not include charitable remainder trusts

e. Code Section 2603 – imposes GST tax on the property constituting the transfer unless the trust provides otherwise by direct reference[26]

4. In many other areas, including pensions and IRAs, federal law is silent.

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[26] Where there is a GST marital exempt and a GST marital non-exempt trust, it is usually best to direct that all estate taxes attributable to those two trusts be paid to the degree possible from the GST non-exempt trust

H. Working the Transfer Tax System

The transfer tax planning component of estate planning is sometimes referred to as the "tail that wags the dog". Tax thinking should not be as important as it is, given all the other things our clients want to think about and do, but the fact remains that the less money that goes for taxes means that much more is available for the grantor's beneficence.

1. Three - step thinking:

    a First, take maximum advantage of the unified credit/applicable exclusion amount:

        (1) The federal amount, including DSUEA; and

        (2) The much smaller, more troublesome Illinois amount; then

    b. Apply marital deduction matrix, if suitable; then

    c. GST structure

    d. Requires strict attention to planning, asset allocation, and drafting, to achieve the various balance points, and avoid over funding either the credit shelter trust(s), or the marital trust(s)

2. Formula language is unavoidable. Rarely do we know, at the date of preparing an estate plan:

    a.. Which spouse will die first, or when

    b. How much property value, if any, will pass by contract (like pension plans) or by joint ownership, or

    c. The total value of the first spouse's estate

3. Two principal funding formulas for separating assets into the credit shelter portion(s) and the marital:

    a. "Pecuniary formula" is based on a specific dollar amount:

(1) "to the trustee of the Family Trust the largest pecuniary amount as finally determined for federal estate tax purposes that results in the lowest possible total of: (i) federal estate taxes; and (ii) state death taxes, that are payable from all sources as a result of Grantor's death, ..."

(2) "to the trustee of the Marital Trust "the smallest pecuniary amount as finally determined for federal estate tax purposes, if any, which if allowed as a federal [Illinois] estate tax marital deduction for federal [Illinois] estate tax purposes would result in the lowest possible total of: (i) federal estate taxes; and (ii) state death taxes, that are payable from all sources as a result of Grantor's death, ..."

b. Fractional share formula is based on a fractional share of the total, with defined numerator and denominator:

(1) "to the trustee of the Family Trust a fraction of the net estate, the numerator of which shall be the remaining applicable exclusion amount, and the denominator of which shall be the value of the net trust estate as finally determined for federal transfer tax purposes."

(2) "to the trustee of the Marital Trust a fraction of the net estate, the numerator of which shall be the smallest amount, if any, which if allowed as a federal [Illinois] estate tax marital deduction for federal [Illinois] estate tax purposes would result in the lowest possible total of: (i) federal estate taxes; and (ii) state death taxes, that are payable from all sources as a result of Grantor's death, and the denominator of which shall be the value of the net trust estate as finally determined for federal transfer tax purposes."

c. Each can be written to define either the marital or the credit shelter first, with the residue of the estate passing to the other

(1) Pecuniary (or, fractional) *credit shelter* lead, followed by a residuary marital bequest

(2) Pecuniary (or, fractional) *marital* lead, followed by a residuary credit shelter bequest

(3) Each of the four produces vastly different results from the others.

d. Advantages and disadvantages to each approach. More complicated than it looks, with potential for very nasty surprises flowing from circumstances occurring after death but before division, distribution and funding

(1) Pecuniary gifts skew benefit/harm from increases or decreases in value after death but before distribution; can either help or hurt the residuary taker, and distributions of appreciated property in kind can trigger capital gain to the distributing master trust or probate estate

(2) Funding a pecuniary gift with IRD assets (such as deferred benefit plans) can trigger immediate recognition of taxable income

(3) Fractional gifts allow administrative costs and taxes to be shared proportionately, and generally no capital gains are recognized on distribution if distributed pro rate in kind or "pick and choose" language is included in the trust agreement, but can be more difficult to administer once funded

e. **The point to be remembered** is that each approach has different consequences for different classes of beneficiaries, and there is no safe, standard, one-size-fits most approach:

(1) For a tight-nit "traditional" one-Dad, one-Mom, one-set-of-functional-children-with-no-particular-ax-to-grind family, choosing the appropriate formula may be easy, and hinge strictly on tax/economic considerations[27].

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[27] For example, the "pecuniary marital lead, date of funding valuation" formula works best for capturing all of the Section 2032A deduction for the credit shelter trust.

(2) But, where there may be a second spouse, and prior court orders, and nuptial agreements, or more than one group of descendants from blended families, then gauging which approach works best for which class of beneficiaries can be a hard nut to crack.

(3) Similarly, different assets – cash; farmland; small businesses with buy/sell arrangements; disproportionately funded deferred benefit plans – can call for radically different funding theories, in each case calling for some real thought and study, and often some very intense (and not always wanted) consultations with the client

f. Another option, favored by many practitioners (including this author), is to eschew the credit shelter/marital deduction planning in favor of a single QTIP trust. Allocations and fractional divisions are reserved for Schedules M and R of the federal estate tax return and the separate QTIP schedule attached to Illinois Form 700. This single QTIP approach is made even more attractive by the new Illinois estate tax law, with its own QTIP allowance. A single QTIP qualifying trust with GST apportionment and is illustrated under Item IV.A, beginning on page 28. [28]

4. GST planning builds upon the unified credit/marital deduction provisions, by adding a second structural overlay for allocating the GST exemption amount

a. Aimed at keeping the property insulated *after* it has been plotted through that first transfer tax thicket

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[28] By making only a partial election on the appropriate federal or state estate tax return, the marital deduction and credit shelter portions can be calculated post-mortem to a statistical certainty. This approach has the charm of simplicity and is attractive in those situations where both clients are determined that the surviving spouse should have the benefit of all of the family wealth until the death of the survivor before any descendants step up to take an interest. Moreover, while the single QTIP trust is not the preferred formula for maximizing the benefit available from special use valuation under Section 2032A *for credit shelter purposes*, it is still possible to use the "pecuniary GST Non-exempt lead, date of allocation funding formula" in the trust agreement to move all of the 2032A benefit into the GST exempt portion. Indeed, the QTIP format for the residuary marital trust is almost mandatory for effective generation skipping transfer tax planning. This approach is adopted under

b. Extrapolates upon the first set of formulas and administrative provisions to provide for both:

(1) An additional GST tax matrix, distinguishing the GST exempt and non-exempt funds; and

(2) Highly targeted and flexible trust administration provisions meant to withstand multiple generations of changed circumstances

Although wildly different from the unified gift and estate tax scheme of Chapters 11 and 12, the Chapter 13 GST tax is still an extension of the existing transfer tax system; it cannot, and does not, exist without several shared points of reference. The most important of these is the segue between the familiar unified credit/marital deduction provisions, on the one hand, and the individual GST exemption on the other. The result is the transfer of the property, in trust, to distant descendants without exposing it to estate tax or GST tax during the intervening beneficial use.

III. SETTING THE STAGE:

STRUCTURING THE BENEFICIAL INTERESTS AND FIDUCIARY APPOINTMENTS

Naturally, the more you know about the client and his/her business, the more effective the planning. Overkill is not required, but the attorney *must* have a firm understanding of the family, the financial context, and the beneficial objectives to be addressed, while always being willing to shift strategies in accordance with the client's own peculiar family sociology. Some family matters to consider include:

- The age; mental, physical and emotional health; and overall competence of the client, while looking for signals of disproportionate/undue influence
- Spouses – past, current, potential future, and domestic partners
- Personal residence and domicile
- ALL descendants/children, including "his, hers and ours"; also, in vitro and posthumous
    - Special needs/special skills/business succession players
    - Disabilities, current or future; conflicts of interests
    - Behavioral/legal/insolvency problems; citizenship and marital status

** Estrangements

** Minors and their guardians, especially hostile guardians

* The relative degree of cooperation among all the players, and means to anticipate, deflect, or neutralize trouble

Similar attention, of course, must apply to the client's business and personal assets, liabilities and existing tax context. Intricate business, financial, and tax issues usually means complicated trust planning:

* Obvious, traditional assets, such as businesses, land, equipment, cash, securities, retirement funds, life insurance, contract payments receivable; but also,
* Non-traditional assets, such as intellectual property, choses in action, out of state property, digital assets, frozen genetic material, prior inheritances, limited and general powers of appointment, and any existing trust interests[29]
* Direct and contingent debts, including support orders, nuptial agreements, buy-sell agreements, prior court orders, pending or potential litigation; be alert to fraudulent transfer issues[30]
* Previous gifts, application of unified credit, and GST exemption allocation; balancing the advantages or disadvantages of inter vivos gifts against testamentary dispositions

Where do the client's hopes and dreams lie, and how can you as the attorney facilitate them? Frequently if not quite always we find that the client and his family is for the most part functional, and endorse the personal and financial advantages offered by long-term trusts in order to:

* Assure the predictable flow of all trust income for select family members, including surviving spouses, descendants, and options for descendants' spouses, according to the client's own sense of need and priorities
* Provide for the temperate distribution and/or use of principal according to definable standards.
* Protecting an"active" farmer child's right to farm ground while preserving the other, non-farming descendants' right to the landlord's share of the income.

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[29] More than once your author has drafted current estate planning to pass into existing trusts created by the client's parents.

[30] The Illinois Uniform Fraudulent Transfer Act (740 ILCS 160/1 - 12).

* Applying the suitable tax formulas to assure the best advantage of marital deduction, credit shelter and GST exemption amounts, and preserving the Section 2032A Special Use Valuation option if the family qualifies and desires to accept the long term restrictions on use and transfer
* Insulating the trust property from the claims and demands of predators.

Planning prudently, with the right blend of precision, discretion, and flexibility in order to minimize risks, while preserving benefit, access, and control in each immediately successive generation, and without undue taxation, can include procedures that:

* Names spouses/children as Trustees or Co-Trustees, or each child as Trustee or Co-Trustee of his or her own sub-divided trust
* Allows an interested Trustee/beneficiary access to principal for health, education, maintenance and support (the "ascertainable standard" safe harbor afforded under Internal Revenue Code Sections 2041 and 2514)
* Gives each child/beneficiary a *limited* power of appointment to end the trust or continue it on – or to redirect it – as he or she thinks best. This option extends planning discretion to each successor generation and preserves priceless flexibility; however, this flexibility can also be limited by terms restricting the class of permissible appointees and other terms of appointment

The net effect is to give each tier of beneficiaries -- spouses, then children, appointees and/or grandchildren -- substantially all of the practical benefit of outright ownership without the tax burdens or risks of loss. Since no beneficiary is an outright owner, the trust res generally cannot be reached by the beneficiary's personal creditors, including personal nuptial and tax obligations. Conceptually, the trust can endure indefinitely; however, even if the trust does not qualify as a perpetual interest trust[31], it may endure for "lives in being

[31] 765 ILCS 305/3(a-5). A simple opt-out from the RAP will do, if desired:

This trust is a Qualified Perpetual Trust as defined and provided by 765 ILCS (a-5), and by these specific terms the rule against perpetuities does not apply. No Trustee's power to sell trust property shall be construed to the contrary.

plus 21 years”, which under existing facts should be sufficient to cover two, three, four or more generations after the creator's death -- an ample term. It is your author’s experience that once these advantages are explained and considered, the children are often the most enthusiastic advocates of the plan.

Selecting the trustee is key, and deserves a protracted word. The right trustee can occasionally salvage a bad plan, but a bad trustee can wreck the best of thinking and drafting. Sometimes it is a good idea to appoint a professional corporate fiduciary; equally often it is better to name a family member – sometimes an “interested” family member; sometimes a “disinterested” family member; and, sometimes it is a good idea to name both as co-fiduciaries with carefully defined and allocated responsibilities and authorities.

The traditional corporate trust department of 25 years ago bears little resemblance to its modern counterpart, and concurrent with that evolution we have found ourselves employing more and more non-professionals -- especially, family members -- as “boss” of the entrusted family venture. Practically every trust officer wants to do a good, conscientious job; to be responsive to his/her beneficiaries; to be professional, impartial, thoughtful and effective. But trust officers are not free agents: they work for the trust department, which in turn is a division of some other financial services enterprise, which exists to make money for its owners/stockholders (and those owners can change quickly and unpredictably.) Making money for the owners is not always consistent with providing the hands-on service that was the hallmark of the loss-leading trust departments of yore – and few will argue that the trend is to provide more wealth management (i.e., investment and financial services) than beneficiary services, and that the standard of training and experience is shifting away from the law and in favor of business and accounting backgrounds. In some of the more drastic cases, the trust departments have become aggressive profit centers where fewer and fewer services are being performed by fewer and fewer people with less and lesser training – while charging the highest fees the market will bear and the courts will allow.

However, that opt-out *could* cost the GST exemption of a previously exempt trust. Treas. Reg. 26.2601-1(b)(v)(B) provides that the release, exercise or lapse of a non-general power of appointment is not treated as a constructive addition to a trust if such power of appointment is created in a gst-exempt irrevocable trust and a power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period beyond the perpetuities period applicable to the original trust (with a safe harbor 90-year perpetuities period). This rule appears to preclude the exercise of a power of appointment to create a dynasty trust without busting the GST exemption of the trust.

Contrast that with our increasingly more informed and more highly-educated client base. These new folks -- the Gen-Xers and Gen-Y/Millenials who often are the ultimate objects of our clients' bounty -- are inculcated to believe in themselves and their inherent abilities, and fluent in research methods that some of us find a little astonishing. These client/beneficiaries want to be in charge; they do not want to pay for services and information that should be "for free"; and, they expect us to structure the family succession plan accordingly.

So, in the first case, you have traditional trust departments, with their steadiness, continuity, training and resources, that:

* Don't die or divorce or disappear
* Don't steal the money, or lose the assets
* Have experience and skills
* Are "disinterested" -- which can be very important for tax thinking
* Have access to outside advisers, including legal counsel, who can help implement and interpret in the face of changing circumstances, and manage or defuse disputes, and
* Generally administer the trust in a competent, professional way.

There will never be a shortage of need for those virtues. There will always be complex situations and family dynamics that require them; and, even in the most tightly structured family plans, there will almost always be a role for a corporate trustee somewhere in the equation.

In contrast, you can have family members running their own show, who:

* Frequently die, divorce, suffer physical or mental disability, or sometimes just disappear -- and rarely at a convenient moment
* Statistically, a few will steal or lose something sooner or later
* Often lack necessary experience, skills – and all-too-often, good sense
* Are far from "disinterested" -- which means that, in addition to being willing to occasionally indulge in retribution and other mischief, they are at risk of countless tax potholes
* May or may not choose to consult business, financial, or legal counsel when prudent or necessary (they cost money), and
* May or may not administer the fiefdom competently or wisely.

Drafting for the corporate fiduciary is by far the easier. There are far fewer tax traps and they will even give you their preferred forms[32]. So, in the absence of institutional strength and tax insulation, the drafting in favor of the family fiduciary requires all that more thought, to provide:

* Guidance and advice on what to do when – largely in the form of clearly worded mandates, supplemented by equally precise precatory explanations and statements of purpose and desires
* Insulation from unwanted tax events, which means the very careful use of special and general power of appointment principles
* Conflict management, including defining what is and is not a conflict of interest; who gets the ultimate benefit and makes the ultimate decisions among competing authorities and interest holders; addressing unmet expectations; mediation, as a means of conflict avoidance; arbitration and litigation, as a means of conflict resolution; and, the consequences of intransigence
* Reformation in the event of radically changed circumstances.

The single most important criterion is character: someone who is well intended and conscientious. Education, training, geography, even age don't matter so much as an honest disposition and a willingness to seek advice and listen to it.

Consider this comprehensive provision clause for the appointment, succession, removal and replacement of various trustees at various stages of administration:

ARTICLE THREE: Trustees and Succession.

A. For so long as Grantor or "Grantor's Spouse", MOTHER FARMING, is living:

1. Grantor shall serve as sole Trustee until Grantor's death, resignation, or "disability" (as that term is hereinafter defined).

2. When Grantor ceases to serve as Trustee then Grantor's Spouse shall succeed Grantor as Trustee.

3. At such time as both Grantor and Grantor's Spouse should for any reason fail to become or cease to serve as Trustee, then the successor Trustee shall be the following, in the order named:

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[32] Which almost never include provisions for removal and replacement.

FIRST: **Such one or more adult persons, or such one or more legal entities empowered to administer trusts, as the last of Grantor or Grantor's Spouse may appoint by a signed instrument (including a Will) specifically referring to this limited power of appointment;**

SECOND: **In default of such appointment, then "Grantor's Children", DAUGHTER FARMING and BROTHER FARMING, as Co-Trustees, or the survivor of them as sole Trustee;**

THIRD: **Such one or more adult persons, or such one or more legal entities empowered to administer trusts, as the last of Grantor's Children may appoint by a signed instrument (including a Will) specifically referring to this limited power of appointment; and,**

FOURTH: **In default of appointment, THE FIRST TRUST BANK, of Post Oak, Illinois, or its corporate successor shall serve as sole Trustee.**

C. Subject to the foregoing, and the provisions of said ARTICLE NINE below, which shall be read in concert with this paragraph, and except as otherwise limited by the valid exercise of any power of appointment pertaining to successor Trustees herein provided, each person who becomes a Trustee pursuant to the provisions of this instrument, except a Trustee who has been removed from office by a beneficiary pursuant to Paragraph E. below, shall have the limited power to appoint such one or more adult persons, or such one or more legal entities empowered to administer trusts, as his or her Co-Trustee or as successor Trustee for any Trust for which he or she is serving as Trustee or Co-Trustee. This power may be exercised at any time, from time to time, or upon the Trustee's death, by a signed instrument in writing (including a Will) specifically referring to this limited power of appointment.

D. If any named or appointed Trustee should fail to become or cease to serve as Trustee for any reason (including without limitation as a result of death, removal, resignation, or "disability"), and in default of appointment, and as a result there be no Trustee then serving for a Trust created or appointed pursuant to the provisions of this instrument, the Trustee for that Trust shall then be such one or more adult persons, or such one or more legal entities empowered to administer trusts as may be selected by a majority of the then-current income beneficiaries of that Trust (which selection may be made by a beneficiary's legal or natural guardian or guardians if he or she is then under a legal disability or is a minor) voting by weight of their respective income shares.

E. In addition to the foregoing general provisions governing the succession of Trustees:

1. Any Trustee may resign as Trustee of any one or more Trusts (without being required to resign as Trustee of any other Trust) upon the giving of thirty days' prior written notice, duly signed and delivered to all the then current beneficiaries affected thereby.

2. During the Grantor’s lifetime, any Trustee may be removed by the Grantor, with or without cause, and at any time, which power to remove may be exercised only by the Grantor acting alone in the Grantor’s own individual and personal capacity, and not by any agent or guardian.

3. Upon the death of the Grantor leaving the Grantor’s Spouse surviving, and during the Grantor’s Spouse’s lifetime, any Trustee may be removed by the Grantor’s Spouse, with or without cause, and at any time, which power to remove may be exercised only by the Grantor’s Spouse acting alone in the Grantor’s Spouse’s own individual and personal capacity, and not by any agent or guardian.

4. Subject to Subparagraphs E.2 and E.3 immediately above, any Trustee OTHER THAN GRANTOR, GRANTOR’S SPOUSE, GRANTOR’S CHILDREN AND THEIR RESPECTIVE APPOINTEES, **may be removed, with or without cause, by the majority of the then-current income beneficiaries of a Trust upon the giving of thirty days' prior written notice delivered to the Trustee (which notice may be made by a beneficiary's legal or natural guardian or guardians if he or she is then under a legal disability or is a minor) voting by weight of their respective income shares.**

5. Notwithstanding the foregoing provisions of this Paragraph E above, any Trustee who is determined to be "disabled" (upon the conditions and in the manner hereinafter provided) shall immediately, and for the remaining term of that disability be disqualified to serve as Trustee. This disqualification shall endure through the entire period of disability, but shall end when the disabling condition ends, at which time that person may be restored as Trustee. In such event the duly nominated or appointed successor Trustee shall immediately assume the office of Trustee as hereinafter provided.

IV. A SYSTEMATIC EXAMPLE

No matter which tax funding formula is embraced as the beginning point, there is a consistent pattern to most GST-oriented estate plans for a married couple with competent descendants and combined assets of more than the applicable exclusion amount. The following example reflects your author’s own experience and peculiar preference for these long term, tax-advantaged and asset protected trusts, and some of the methods necessary for making them work. Presented in outline form, with comments and some possible language, this example is meant to trace this pattern in a systematic way, conceding of course that every plan (and attorney's philosophy) is individual, and that there will always be variations to accommodate practical realities, styles, and preferences. As will always be the case, there is no substitute for careful, detailed planning and drafting when putting these complex estate plans together

A. The Single QTIP Qualifying Trust with GST Apportionment

For many families, where the administrative burden of multiple trusts is barely tolerated and never welcomed, and where the client is intent on providing first for the surviving spouse to the initial exclusion of the children, there is a simple charm to eschewing the A/B/C funding morass in favor of a single 2056(b)(7) fund that will be administratively severed by fractional formula on Schedule M of the estate tax return. Since Father Farming's share could exceed the GST exemption amount, the GST apportionment[33] between the exempt and non-exempt portions is built on top of the marital instructions. Note the "pecuniary Non-GST exempt lead" allocation formula, which captures the bulk of the 2032A savings for the exempt fund, and the very broad precatory tax instructions in Paragraph G:

ARTICLE SEVEN: Disposition Upon Grantor's Death.

This Agreement, as amended from time to time, shall become irrevocable upon Grantor's death. At such time the Trustee shall collect any property directed to pass to the Trust as a result of Grantor's death, whether under Grantor's Will or otherwise, and shall thenceforth hold, administer and distribute the Trust Estate according to the following provisions:

A. [debts; taxes; costs]
B. [specific gifts; charities]
C. [personal effects]
D. Subject to the foregoing, the Trustee shall then divide the Trust Estate then remaining (the "Net Trust Estate") into two portions, referred to as the "Non-Exempt Portion" and the "Exempt Portion".

1. The Trustee shall allocate to the Non-Exempt Portion a pecuniary amount equal to the amount, if any, by which the value of Grantor's Trust Estate (as finally determined for federal estate tax purposes) exceeds the "GST Exempt Amount".

2. The Trustee shall allocate the balance and remainder of the Net Trust Estate to the Exempt Portion.

3. Any property allocated in kind to the Non-Exempt Portion shall be valued for the purpose of satisfying the pecuniary amount required at its fair

33 Commonly known as a "qualified severance". Code Section 2642(a)(3). Treas. Reg. 26.2642-6.

market value as of the actual date of allocation.

4. To the extent possible while consistent with the preceding requirements of this Paragraph D., Grantor's "Farm Property" (as hereinafter defined) shall be allocated to the Exempt Portion.

5. The "GST Exempt Amount" described in Subparagraph D.1. above means the unused portion of Grantor's generation skipping tax exemption allowable to Grantor under Internal Revenue Code Section 2631, reduced by the aggregate amount of allocations of such exemption before or after Grantor's death <u>other than</u> any allocations to the Exempt Portion.

E. If Grantor's Spouse survives Grantor, both the "Non-Exempt Portion" and the "Exempt Portion" shall pass to the "Marital Trust", to be further divided, held, administered and distributed pursuant to ARTICLE EIGHT below. All references to the Marital Trust or Trusts(whether one or more) shall apply to both the Non-Exempt Portion and the Exempt Portion unless otherwise stated; provided, however, that each such Portion, and any subdivision of each such Portion, shall at all times be segregated from the other as distinct Trust Estates.

F. If Grantor's Spouse <u>does not</u> survive Grantor, both the "Non-Exempt Portion" and the "Exempt Portion" shall pass to the "Descendants Trusts", to be further divided, held, administered and distributed pursuant to ARTICLE NINE below. All references to the Descendants Trusts (whether one or more) shall apply to both the Non-Exempt Portion and the Exempt Portion unless otherwise stated; provided, however, that each such Portion, and any subdivision of each such Portion, shall at all times be segregated from the other as distinct Trust Estates.

G. In furtherance of the foregoing provisions, and not in derogation thereof, it is the Grantor's intention that the Trustee shall not be required to administer any Trust Estate that is only partially exempt from generation skipping taxes, but instead shall monitor the Trust Estates throughout the term of the Trust(s) provided for herein so as always to provide that: (i) the "Exempt Portion" shall consist of that portion of a Trust Estate to which sufficient generation skipping transfer tax exemption (as that term is defined under Internal Revenue Code Section 2631 and supporting regulations) has been allocated by the Transferor of that property (whether the Grantor as aforesaid, or some successor interest holder in the manner hereinafter provided) so as to produce an inclusion ratio of zero for that Portion; and, (ii) that the "Non-Exempt Portion" shall consist of all that part of a Trust Estate other than the Exempt Portion. It is the Grantor's desire, which is not binding on any beneficiary hereunder, that a taxable general power of appointment will be kept in effect over the Non-Exempt Portion property when the beneficiary believes that the inclusion of the property subject thereto in such beneficiary's gross estate for federal estate tax purposes may achieve a significant savings in transfer taxes by subjecting the property to the federal estate tax rather than a generation skipping transfer tax imposed under Chapter 13 of the Internal Revenue Code; and, that by providing for the creation of taxable general powers of appointment by certain beneficiaries as hereinafter provided the beneficiaries may make optimum use of the generation skipping transfer tax exemption (as that term is defined under Internal Revenue Code Section 2631 and supporting regulations) available to each

such beneficiary, so that property previously held as part of the "Non-Exempt Portion" might thereafter be held as part of the "Exempt Portion." In apportioning property between the Non-Exempt Portion and the Exempt Portion:

1. The Trustee may rely upon the allocations of generation skipping transfer tax exemption made by the Transferor of the property to the Trust, and shall adjust the apportionments to conform with any later allocations, or revisions to allocations or values upon audit, in order always to maintain a zero inclusion ratio for the Exempt Portion; and,

2. If any such property was valued for the purposes of allocating generation skipping transfer tax exemption at a value other than the fair market value as of the date of the transfer (or deemed transfer), any property so apportioned to one or another Portion to maintain the zero inclusion ratio shall be selected in such manner that such property shall have an aggregate fair market value fairly representative of the appreciation and depreciation in fair market value since the date of the original transfer of all property available for apportionment on each date of apportionment (or re-apportionment).

B. The Marital Trust

These marital trust provisions begin with the usual 2056(b)(7) QTIP model provisions, but:

1. Paragraph B. (and later language) anticipates this trust being a qualified beneficiary for any retirement plans, sufficient to afford asset protection without triggering immediate recognition as could be required by a pecuniary formula

2. Allows the surviving spouse ascertainable standard access to principal assets

    a. “other than” farm property, which is restricted under later provisions; and

    b. subject to disqualification in the event of disability under later provisions

3. Allows the surviving spouse a carefully crafted limited power of appointment to re-direct the trust estate among family members, but subject to a number of boundaries to his/her discretion

4. To the extent not otherwise appointed, directs re-shuffling the marital exempt and non-exempt funds to maximum advantage per Rev. Proc. 64-19 “fairly representative” language, and the payment of resulting federal and Illinois estate tax from the remaining Non-Exempt fund

<u>ARTICLE EIGHT</u>: The Marital Trust Provisions.

The Trustee shall hold and administer the Marital Trust estate for the exclusive lifetime benefit of Grantor's Spouse in conformity with Grantor's intention to establish a transfer in trust of qualified terminable interest property that is eligible for the federal and Illinois estate tax marital deduction within the meaning of Internal Revenue Code Section 2056(b)(7). All references in this instrument that are inconsistent with this overriding intention shall be deemed amended or, if necessary, deleted, in order to conform with this overriding intention. Except for the power to make tax elections [including specifically but without limitation the power to make partial or formula elections for qualified terminable interest property in order to obtain maximum lawful transfer tax advantage, which power is hereby specifically created in the Trustee] the Trustee shall have no power over the Trust Estate which if exercised could defeat the federal and Illinois estate tax marital deduction eligibility anticipated by this instrument. Pursuant to this overriding intention:

A. Commencing upon Grantor's death the Trustee shall pay to or for the benefit of Grantor's Spouse all of the net income of the Marital Trust in regular monthly or other convenient installments, and at least annually.

B. If the Trust is then the owner or the beneficiary of an individual account in any employee benefit or retirement plan, or any individual retirement or deferred benefit plan, the income of the individual account shall be income of the Trust. All of such income shall be timely withdrawn and paid to or for the benefit of Grantor's Spouse in regular installments, and at least annually.

C. The Trustee shall also pay to or for the benefit of the Grantor's Spouse so much of the Marital Trust principal (other than "Farm Property", as that term is hereinafter defined) as may be required from time to time to provide for Grantor's Spouse's health, education, maintenance and support in reasonable comfort only. Grantor's primary concern during the life of the Grantor's Spouse is for the Grantor's Spouse's support in reasonable comfort, without regard to the Grantor's Spouse's other assets or income, and in priority over the interest of any potential successor beneficiary; provided, however:

1. That all such distributions of principal shall always adhere to this ascertainable standard; and,

2. That all distributions of principal shall always be subject to the specific restrictions that apply in the event of the disability of a beneficiary that are hereinafter provided.

D. The Trustee shall make no unsecured loans from the Marital Trust Estate without the written consent of Grantor's Spouse, and any unproductive property held in the Marital Trust shall be sold by the Trustee upon being directed to do so by the Grantor's Spouse.

E. Upon the death of the Grantor's Spouse the accrued and undistributed income of the Marital Trust shall be paid to the estate of Grantor's Spouse.

F. The Marital Trust shall terminate upon the death of Grantor's spouse, whereupon the Trustee shall then distribute the Marital Trust Estate remaining in compliance with the following provisions:

1 The Grantor's Spouse shall have the limited testamentary power to appoint all, any portion of, or any beneficial interest in the Marital Trust Estate (including principal, income, the power to appoint successor interests or successor Trustees, and any other right, prerogative or privilege not elsewhere restricted by this instrument), outright or in trust, but only to or for the benefit of such one or more of Grantor's descendants then living or thereafter born. This power may be exercised by the Grantor's Spouse in such portions, amounts or manner as the Grantor's Spouse may appoint by a Will which specifically refers to such limited power of appointment, and may be exercised by the Grantor's Spouse in his/her sole and unfettered discretion and without application of any fiduciary principles or standard of reasonableness; provided, however, that no such appointment shall be effective:

a. to appoint such Trust property in a manner resulting in any Trust having a federal generation-skipping transfer tax inclusion ratio greater than zero and less than one;

b. to allow the distribution of Trust principal free of trust to any person who has not attained the age of 25 years;

c. to allow the sale, partition, mortgage, distribution free of trust, or other disposition of any separate parcel of "Farm Property" (as that term is hereinafter defined) except in strict compliance with the provisions therefor that are hereinafter provided; or,

d. to create in any appointee a taxable general power of appointment over the Exempt Portion of a Trust Estate or Trust property (although the limited power may be exercised to create in the appointee a general power of appointment over any Non-Exempt Portion so appointed).

2. Subject to the foregoing, and except as otherwise effectively appointed, the Trustee shall then distribute the Marital Trust Estate remaining as follows:

a. The Trustee shall add to the Marital Exempt Trust a pecuniary amount of the Marital Non-Exempt Trust property equal to the unused portion of Grantor's Spouse's generation skipping transfer tax exemption (as described in Internal Revenue Code Section 2631) remaining after all allocations of such exemption before or after Grantor's Spouse's death <u>other than</u> to Grantor's Marital Exempt Trust. The Trustee may rely on the certification of his or her personal representative as to such amount.

b. The Trustee shall then pay, from the Marital Non-Exempt Trust property remaining, if any, any federal estate tax and state death taxes otherwise recoverable from the Marital Trust by reason of the death of the Grantor's Spouse, but only to the extent such payment will not result in a federal generation-skipping transfer tax inclusion ratio for the Marital Exempt Trust greater than zero.

c. Subject to the foregoing, the Trustee shall then distribute both the Marital Non-Exempt Trust and the Marital Exempt Trust remaining to the Trustee or Trustees of the Descendants Trusts, to be held, divided, administered and distributed pursuant to ARTICLE NINE below. The Marital Non-Exempt Trust property shall be made part of the "Non-Exempt Portion" and the Marital Exempt Trust property shall be made part of the "Exempt Portion." All references herein to the Descendants Trusts (whether one or more) shall apply to both the Non-Exempt and Exempt Portions unless otherwise stated; provided, however, that each such Portion, and any subdivision of each such Portion, shall at all times be segregated from the other as distinct Trust Estates.

d. Any property allocated in kind to the Marital Exempt Trust pursuant to Sub-subparagraph F.2.a. above shall be valued for the purpose of satisfying the pecuniary amount required in that Sub-subparagraph at the value of such property as finally determined for federal estate tax purposes in Grantor's Spouse's estate, or, if such item is an investment or reinvestment of property included in his/her gross estate for federal estate tax purposes or the proceeds of any sale or other disposition of property so included or of any such investment or reinvestment, at the federal income tax basis of such property at the actual date of allocation to such trust; provided, however, that any property so allocated to the Marital Exempt Trust shall be selected in such manner that such property shall have an aggregate fair market value fairly representative of the appreciation and depreciation in fair market value since Grantor's spouse's death of all property available for allocation on each date of allocation.

C. The Descendants Trusts

These provisions supplement the division/disposition terms of the preceding Article, and govern the transition into the long term trust or trusts. Both parents are gone, and the property that has made its way to this stage is now net of estate tax and segregated for GST tax purposes. One of two things can now occur: the Descendants' Trust can become a functional single entity, in which the children (or a predeceased child's descendants) have undivided interests[34], or the Trustee may, after gathering things together, promptly disperse them again by creating separate "Descendants Trusts" for each beneficiary.

What to do at this point is a crucial ultimate decision for the family, and deserves a lot of consideration of all the factors mentioned earlier, and then some: the degree of family cooperation; who's in charge; the desire to hold a single asset or business together; the relative competence or special needs of the family; and so forth. On balance, however, experience seems to show that most first-generation beneficiaries -- those who are being skipped for tax benefit and asset protection purposes -- will more readily accept the totality

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34 Thus invoking the "substantially separate and independent share" requirements of Code Section 2654 and Treas. Reg. 26.2654-1(a).

of the plan if each feels that he or she is in nominal control of his or her own inheritance and its destiny, since expectations of fairness count. More often than not this will mean forming separate trusts , and probably naming each adult beneficiary as at least a Co-Trustee. Here is one approach suitable to a farming family context:

ARTICLE EIGHT: The Descendants Trusts Provisions

The Trustee shall divide all of the "Exempt Portion" and "Non-Exempt Portion" property directed to pass to the Descendants Trusts (while maintaining the distinction between the Exempt Portions and Non-Exempt Portions) pursuant to the foregoing into equal shares of each such Portion. One share of the Exempt Portion and one share of the Non-Exempt Portion shall be created for each of DAUGHTER FARMING and BROTHER FARMING, (the "Grantor's Children" or "Child") living at that time, and one share of the Exempt Portion and one share of the Non-Exempt Portion shall be created for each deceased Child of Grantor who has one or more descendants then living, which shares shall be further divided into shares for such descendants, per stirpes. Each resulting share of the Non-Exempt Portion and the Exempt Portion shall be named for the Child or other descendant beneficiary for whom it was created and thereafter held and administered as a separate Descendants Trust for his or her benefit according to the following provisions:

A. The Trustee shall pay to or for the benefit of the beneficiary all of the net income of the Trust in regular monthly or other convenient installments, and at least annually.

B. The Trustee shall also pay to or for the benefit of the beneficiary so much of the Trust principal (other than "Farm Property", as hereinafter defined) as may be required from time to time to provide for his or her health, education, maintenance and support in reasonable comfort only. Grantor's primary concern during the life of each Descendants Trust's current beneficiary is for the support in reasonable comfort of that current beneficiary, without regard to that beneficiary's other assets or income, and in priority over the interest of any potential successor beneficiary; provided, that all such distributions of principal pursuant to this Paragraph shall always adhere to this ascertainable standard.

C. In addition, and during the month of June of each calendar year only, the beneficiary shall have the right to withdraw or demand distribution, free of trust, an amount of Trust principal (other than "Farm Property", as hereinafter defined) that does not exceed the greater of: (i) FIVE THOUSAND DOLLARS ($5,000.00); or (ii) FIVE PERCENT (5%) of the value of the Descendants Trust on June 1 of each year. This right of withdrawal shall be non-cumulative, may be exercised only by a signed written instrument delivered to the Trustee during the month of June each calendar year, and shall lapse if not exercised on or before June 30 of each year.[35]

[35] See, Code Sections 2514(e) and 2041(b)(2). The price of this flexible access is that the 5% value of the trust will be includible in the beneficiary's estate if he or she dies before the power lapses. That is why the window is open for just one month during the year.

D. Notwithstanding the provisions of Paragraphs A. - C. above, all distributions of income and/or principal from each Descendants Trust, however or whenever created, shall be subject to the specific restrictions that apply in the event of the disability of a beneficiary that are hereinafter provided.

E. It is Grantor's expectation that no distribution of principal shall be made from any Exempt Portion until substantially all of the Non-Exempt Portion of that Descendants Trust has been exhausted.

F. Upon the death of each Descendants Trust beneficiary his or her Descendants Trust Estate shall pass as follows:

1. Each such beneficiary shall have the limited testamentary power to appoint the entitlement to all the annual income from any specific part, or all, of the Non-Exempt Portion of his or her Trust Estate, to or for the exclusive benefit of his or her spouse, for the term of the beneficiary's spouse's entire life only. This power may be exercised by a Will which specifically refers to this limited power of appointment; provided, however, that the exercise of this limited power of appointment shall not be effective unless it creates in the beneficiary's spouse the additional general testamentary power to appoint the property from which the income entitlement flows to the beneficiary's spouse's estate.

2. Subject to the foregoing, each such beneficiary shall also have the general testamentary power to appoint any specific portion, or all, of the "Non-Exempt Portion" of the Trust Estate, not effectively appointed pursuant to Paragraph F.1. above, to or for the benefit of the creditors of his or her estate, but only by a Will which specifically refers to this general power of appointment; provided, however, that the exercise of said power shall not be effective absent the written consent of the then-acting president of the First State Bank, of Hometown, Illinois, or its corporate successor, which consent may be granted or withheld without application of any fiduciary principles or standards of reasonableness.

3. Subject to the foregoing, each such beneficiary shall also have the limited testamentary powers:

a. To appoint the right to receive any part or all of the income from the "Exempt Portion" of his or her Trust Estate to or for the benefit of his or her spouse for any period of time not to exceed the spouse's lifetime.

b. To appoint all, any portion of, or any beneficial interest in the Exempt Portion, and that part of the Non-Exempt Portion not effectively appointed pursuant to Subparagraph F.2. above, of his or her Trust Estate (including principal, income, the power to appoint successor interests or successor Trustees, the power to create successive limited or general powers of appointment, and any other right, prerogative or privilege not elsewhere restricted by this instrument), outright or in trust, but only to or for the benefit of such one or more of Grantor's descendants (other than the beneficiary/power holder) then living or thereafter born.

c. In each case these powers may be exercised in such portions, amounts or manner as that beneficiary may appoint by a Will which

specifically refers to the power of appointment being exercised; provided, however, that no exercise of a limited power of appointment shall be effective:

i. to appoint the Exempt Portion of the Trust property in a manner resulting in any trust having a federal generation-skipping transfer tax inclusion ratio greater than zero;

ii. to allow the distribution of Trust principal free of trust to any person who has not attained the age of 25 years;

iii. to direct the sale, partition, distribution free of trust, or other disposition of any separate parcel of "Farm Property" (as that term is hereinafter defined) except in strict compliance with the provisions therefor that are hereinafter provided; or,

iv. to create in any appointee a taxable general power of appointment over the Exempt Portion of a Trust Estate or Trust property (although the limited power may be exercised to create in the appointee a general power of appointment over any Non-Exempt Portion so appointed).

4. Except as otherwise effectively appointed, then upon the death of: (i) the beneficiary; and/or (ii) the death of the last to die of the beneficiary and the beneficiary's spouse, to the extent that an interest in property appointed for the lifetime benefit of the beneficiary's spouse should inure to the Descendant's Trust upon the death of the beneficiary's spouse, the Trustee shall collect all the property remaining in or passing to the Descendant's Trust pursuant to the foregoing; reapportion the Exempt Portion and Non-Exempt Portion property to reflect any allocations of generation skipping transfer tax exemption taking effect upon the death of the beneficiary and/or the beneficiary's spouse, if any; and then divide all the Exempt Portion and Non-Exempt Portion property (while maintaining the distinction between the Exempt Portions and Non-Exempt Portions) into equal shares of each Portion so as to provide:

a. One such share of the Exempt Portion and one such share of the Non-Exempt Portion for each living child of the deceased beneficiary, and one such share of each Portion for each deceased child of the deceased beneficiary who has one or more living descendants, which shares shall be further divided into similar shares for such descendants, per stirpes; or

b. If the beneficiary is not survived by any descendants, then to provide one such share of the Exempt Portion and one such share of the Non-Exempt Portion for each surviving sibling of the beneficiary, and one such share of each Portion for each deceased sibling who has one or more living descendants, which shares shall be further divided into similar shares for such descendants, per stirpes.

c. If the beneficiary is not survived by any descendants or siblings, then to provide shares of each such portion for those persons who would inherit from the beneficiary's intestate estate, in the manner and proportions prescribed by the Illinois rules of descent and distribution, but: (i) assuming that all of the Grantor's Descendants spouses were then deceased; and (ii) subject to the

definition of "descendants" hereinafter provided.

d. Each share allocated to one of the Grantor's descendants for whom a Descendants Trust then exists shall be added to his or her Trust Estate. Each share allocated to a new descendant beneficiary shall thereafter be held and administered as a new Descendants Trust. The Trustee shall administer the Exempt Portion and Non-Exempt Portion of that new Descendants Trust, and shall distribute the income and principal thereof to or for the benefit of that beneficiary in the same portions, amounts or manner, and subject to the same restrictions, prerogatives and powers of appointment (including specifically the defined general power of appointment over the Non-Exempt Portion and the defined limited powers of appointment over the Exempt Portion) accorded by this instrument to each of the Descendants Trust's beneficiaries initially.

G. Each Descendants Trust, however and whenever created pursuant to or as a result of this instrument shall terminate at the end of twenty-one (21) years after the death of the last to die of all of Grantor's descendants who are living at the date this instrument becomes irrevocable. Upon such termination, and except as otherwise effectively appointed, each Trust Estate shall vest in those descendants of the Grantor then entitled to or eligible to receive or have the benefit of its income in proportion to his or her fractional income interest(s), per stirpes and not per capita; provided, that with regard to any interest in a Trust Estate which is subject to a then-current entitlement of the income in a spouse of a descendant created through the exercise of a power of appointment, then that interest shall vest, subject to such current income entitlement, in those persons entitled to or eligible to receive or have the benefit of its income immediately upon the death of the entitled spouse, in proportion to his or her fractional income interest(s), per stirpes and not per capita.[36]

Paragraph A., of course, is a QTIP-type mandatory income requirement. But Paragraph B. is a discretionary option creating a power of withdrawal over principal that is subject to an ascertainable standard, suitable for a descendant beneficiary acting as his or her own trustee (but note the limitation on withdrawal of "Farm Property" principal.) The statement of the grantor's priority of purposes instructs the trustee to be generous within the confines of this standard, and provides the interested trustee some shelter from any remainderman's impatience to get his or her hands on his ancestor's money.

How liberal or tight the beneficial terms should be during the children's lives is another hot topic. Most parents (and the skippee children) will want the kids to have rather broad access because, after all, "it's their inheritance." Many GST planners recommend discretionary, as opposed to mandatory income distributions, to avoid leakage and to facilitate greater trust appreciation. But while that is undoubtedly true in principle, the reality

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36 This Paragraph G. assumes the client did *not* opt out from Rule Against Perpetuities treatment, as provided under 765 ILCS 305/3(a-5).

is that undistributed income now hits a 35% income tax threshold at only $11,350.00. Moreover, if the trust mandates annual income distribution the first generation beneficiaries often feel more comfortable taking their full income share without worrying about generational equity. In short, from an accounting, tax, and psychological perspective, providing for mandatory income distribution is the easiest way to go.

Paragraph C. is intended to strike a compromise between the grantor's desire to provide generous access, while limiting the period during which the 5 and 5 amount will be vulnerable to inclusion in the survivor's gross estate. In targeting the mid-year, 30-day term of June, the thought is that the survivor can plan for this withdrawal if he or she wants some extra cash,[37] or let it lapse (with relief) on July 1 if not.

Paragraph D makes all payments of both income and principal subject to the self-amending disability provisions that will convert each Descendants Trust into a special needs trust if necessary.

The layered testamentary powers of appointment in Sub-paragraphs F.1 - F.3 provide a dispositional control mechanism while also assuring that the unused Non-Exempt Portion will be subject to transfer tax in the estate of the beneficiary, and thereby avoid any GST tax. These powers will afford each child the opportunity, presumably many years after the death of the grantor, to reconsider the needs, desires and deserts of the family, and to adjust the distribution of the fund as circumstances may then indicate. The limitation on the class of permissible appointees is inserted as an example, and need not be so limited; it would be equally effective (for tax purposes, if not family sociology) to limit the class to "such persons or entities other than [the beneficiary], his or her estate, his or her creditors, or the creditors of his or her estate".[38]

Finally, Subparagraph F.4 provides one of many possible alternatives for distribution in default of appointment. The fact is that the vast majority of powers are never exercised,

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The grantor trust income tax rules cannot be ignored for this period, but since the survivor has a mandatory income right anyway it would seem that in all but the very largest trusts that burden can be handled with skilled tax reporting on the fiduciary income tax return.

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The broadest drafting possible to avoid general power treatment. Note that another advantage of placing this power in the first tier beneficiary -- whether a child or a surviving spouse -- is to encourage the children and grand children to be kind to the power holder. Cynics can have a field day with this one, but there are plenty of times when the first spouse's primary purpose is to extract that very contribution -- of kindness and attention -- from the potential takers.

and a clear statement of who takes in default of appointment is always desirable.

D. Farm Property and Management

These provisions allow the family to make critical non-tax administrative decisions, such as: (i) the scope of the continued farm operation; (ii) the degree of control to be afforded the continuing farm operator, and the amount of conflict to be endorsed and waived; (iii) the restrictions – if any – that should apply on the disposition of "Farm Property" (a carefully defined term), but with specific exceptions for 1031exchange and carving out the homestead; and, (iv) the source of payments that cannot practically be charged to trust principal. The provisions of this Article are limited in the main only by the family's intentions and imagination; and, for those practitioners who rarely advise farm operators, imagine a widget factory instead, and how these principles can be turned to other uses. Note the condensed but sufficient preferred right of purchase created at the end of Paragraph G.

<u>ARTICLE TEN</u>: Farm Property and Management

Grantor is convinced that his/her family has been blessed with the fruits of the land, land that has been acquired upon the strength of several lifetime's worth of hard work, frugality, and foresight. Preserving that land intact for the benefit of the Grantor's descendants is of utmost importance to Grantor and shall be a primary objective of the Trustee. Accordingly, the Grantor hereby declares and directs:

A. That Grantor considers Grantor's interests in agricultural real estate (and any and all other agricultural real estate held at any time by any one or more Trusts created by or as a result of this instrument, however acquired and wherever situated, including, without limitation, the real estate described on Exhibit A hereto; that portion dedicated to residences, sheds, bins, and other agricultural support facilities without the requirement that said agricultural real estate actually be dedicated to producing crops; and, including specifically any interest in any business or other legal entity that owns an interest in agricultural real estate including without limitation shares in a corporation, a partnership interest in any limited or general partnership, a beneficial interest in or power of direction over a land trust, a membership interest in any limited liability company, or other entity of similar construction or purpose, all of which being referred to herein for convenience as "Farm Property"), to be a sound and proper investment and, subject to the following provisions, expressly authorizes the Trustee to invest in or retain indefinitely any part or all of any Trust Estate in Farm Property, to the exclusion of all other investments if necessary.

B. That the Trustee is specifically authorized and directed to continue to engage in farm operations and the production, harvesting and marketing of farm products; to retain farm management consultants, if desired; to lease land, equipment or livestock for cash or on shares; to purchase and sell, exchange or otherwise acquire or dispose of farm equipment and farm produce of all kinds; to make improvements, construct, repair, or demolish and remove any buildings, structures or fences; to engage

agents, managers and employees and delegate powers to them; to engage in drainage and conservation programs; to terrace, clear, ditch and drain lands and install irrigations systems; to replace, demolish, or repair improvements and equipment; to fertilize and improve the soil; to engage in the growing, improvement and sale of trees and other forest crops; to participate or decline to participate in governmental agricultural or land programs; to perform such acts as the Trustee deems appropriate, using such methods as are commonly employed by other farm owners in the community in which the Farm Property is located; and in general to do all things customary or desirable in farm operations; provided, however, that the Trustee shall at all times conduct its farm operations in compliance with any Internal Revenue Code Section 2032A and/or other beneficial Internal Revenue Code provisions by which a recapture agreement at any time has been made and is in force.

C. That, because of the illiquid nature of Farm Property, and the Grantor's overall preference, the Trustee shall first pay currently from the gross income received from the Farm Property operations all of the expenses of holding and managing the Farm Property, including by way of example and not limitation: all interest and principal due on indebtedness for which the Farm Property (or any portion thereof) was mortgaged as security in Grantor's lifetime (if any), in accordance with the schedule or schedules of payments required by the terms of such indebtedness, and before any penalty may accrue; all taxes and special assessments which may be levied against the Farm Property in a timely manner, and before penalty may accrue; the landlord's share of the cost of improvements, repairs, insurance, crop inputs, costs of preserving productivity and farm operations generally; reasonable cash reserves for depreciation and repairs; costs of administration of the Trust; and all other necessary and reasonable expenses, all of which costs shall be borne by the income beneficiaries without contribution from the Farm Property principal assets or those having a future interest in the Farm Property principal assets. The Trustee shall keep the buildings and improvements thereon insured for their fair insurable value; keep the buildings, waterways, and drainage thereon and easements appurtenant thereto in a reasonable state of repair and upkeep; and, use reasonable efforts to maintain the fertility of the soil; however, the Trustee shall not be required to maintain or insure improvements that become unproductive due to changing circumstances.

D. That the Grantor's son, BROTHER FARMING, shall have the right to tenant-farm the Farm Property as long as he desires and is capable of doing so in accordance with the crop-share lease arrangement now existing between him and the Grantor and such additional terms as he and the Trustee may agree. This opportunity to farm the Farm Property shall not disqualify him from being appointed or serving as a Trustee or Co-Trustee, or as farm manager; but to the contrary, the Grantor emphasizes his intention that any one or more of his descendants may, if otherwise qualified, appointed, or selected, serve in the multiple capacities of Trustee, farm tenant and/or farm manager, none of which shall be construed or interpreted as an actual or potential conflict of interest, nor limited by any duty that he/she disgorge his/her individual tenant's share of the profits according to the lease arrangement. Moreover, the Grantor acknowledges having been fully informed of the apparent conflict of interests inherent to circumstances when the farm tenant also serves as farm manager and/or trustee, and having been so fully informed such apparent conflict is freely and knowingly waived, except for harm actually caused by reason of gross negligence or willful malfeasance, it being the Grantor's intention to empower as tenants, farm managers, and potentially successor Trustee(s)

persons who are members of his/her family and the natural objects of his/her bounty.

E. That the Trustee may consent to special use valuation of Farm Property for death tax purposes or a deferral of payment of federal estate tax or state death taxes, and may accept property which is subject to a lien for the payment of deferred death taxes or which has been specially valued; and, accordingly, the Trustee may take any action consistent with such consent or acceptance including execution of any agreement, consent to imposition of any lien, substitution of any security, acceleration of any payment, assessment of any tax or any other proceedings pertaining to special valuation, in each case without regard to the effect on the relative interests of any beneficiary.

F. That in supplement to the foregoing statements of purpose and declarations and directions, and not in limitation thereof, no beneficiary shall have the right to demand or withdraw and no Trustee shall have the power to sell, mortgage, petition for partition, or distribute as principal free from trust any portion of the Farm Property except:

1. As may prove actually necessary to discharge any federal or state death taxes remaining due upon the death of the Grantor or Grantor's Spouse after all other assets available for that purpose have been exhausted; or,

2. Upon the order of any court of competent jurisdiction having first made its finding that such is necessary for the best interests of all the current and remainder beneficiaries of all Trust Estates generally; however,

3. The foregoing restrictions of this Paragraph F. shall not apply:

a. To that portion of Farm Property constituting a natural, separate residential homestead. In the event any such residential homestead passes into Trust hereunder, the Trustee shall at any time have the power, but not the obligation, to survey, partition, and set aside any said farm homestead (including houses, support buildings, storage facilities and land traditionally not employed for growing crops, and as may otherwise be required by state or local zoning or land use authorities) and offer it for sale at its then-current value upon such terms and conditions as may then be in the best interest of the Trust(s), giving preference to any adult descendant of Grantor who may wish to buy it at its then-current value; or in the alternative, the Trustee may maintain and preserve said homestead for any beneficiary's residential use or as an income-producing property. In calculating value the Trustee may consider contributions, such as buildings and storage facilities, made by current or prior family residents.

b. To prevent the Trustee from exchanging one or more tracts of Farm Property for another, similar tract (or tracts) of agricultural real estate if the Trustee believes such an exchange would benefit the Trust Estate generally in a manner consistent with Grantor's stated intentions under this instrument; or,

c. To prevent the Trustee from conveying any part or all of the Farm Property to any one or combination of a corporation, a limited or general partnership, a land trust, a limited liability company, or other business organization if the Trustee deems such reorganization to be in the best interests of the Trust, and the Trust retains undiluted equitable ownership.

G. Upon termination of the Trust the Trustee shall distribute the Farm Property "in kind" to the vested beneficiaries, and each such distribution shall be conditioned upon a preferred right of purchase hereby created in all the Grantor's descendants per stirpes then living that no such beneficiary may sell or otherwise transfer any right, title or interest in or to any portion of his/her Farm Property without having first offered the subject interest for sale and purchase by any one or more of the Grantor's descendants who, as a condition of such purchase will agree not to reconvey said portion of the Farm Property without again first offering it for purchase by another descendant of Grantor. (The preferred right of purchase shall be for a purchase price equal to an average of two appraisals prepared by licensed Illinois land appraisers familiar with farm values in Post Oak County, and the terms of sale shall be those prevailing for similar sales of farm land on an "arms length" basis within the area. If more than one descendant of Grantor wishes to exercise the preferred right to purchase then each shall be allowed to do so in fractional proportions equivalent to the number participating in the purchase). This provision shall be liberally construed to enforce Grantor's intention to allow his/her descendants to hold on to as much of the Farming Family Farm land as they desire, while being fair to those other vested descendants who want a reasonable opportunity to cash out.

Occasionally, the following 2032A inducement is added:

H. Notwithstanding any dispositive provision herein contained to the contrary, if the refusal of any beneficiary (other than Grantor's spouse) to agree to special use valuation results in a failure to qualify for the election under Internal Revenue Code Section 2032A and the Trustee (or Grantor's executor) is required to pay the federal estate tax and state death taxes attributable to the failure to qualify, then such payment shall be charged without interest as an advancement against the property otherwise distributable to or in trust for such refusing beneficiary and his or her descendants or appointees. All such tax payments shall be reimbursed to the Trustee or executor before any property shall be distributed to or for the benefit of the refusing beneficiary, and before any income or principal distribution shall be made to the beneficiary and his or her descendants or appointees from any trust created by or as result of this instrument. If the failure to qualify for the election under Section 2032A described in the preceding paragraph is caused by the refusal of more than one beneficiary to agree to special use valuation, then such tax payment shall be charged among said refusing beneficiaries' shares in the proportion that each such beneficiary's beneficial interest bears to the total beneficial interests represented by all refusing beneficiaries.

E. Asset Protection, Disability Provisions, and the Special Needs Conversion

Long term trusts require looking out for the unforeseeable, even the unimaginable, including the possibility that a tall strong healthy child or grandchild may fall victim to accident and permanent disability. Rather than cringe from the thought, we should address the problem by availing the "special needs and comforts" trusts for loved ones without exposing trust principal to seizure for reimbursement by public aid agencies that may have provided basic shelter, sustenance and medical care. Volumes have been written on the subject of drafting trusts for the benefit of third parties that can be used for special needs, and while Congress (and the assorted state agencies) are growing ever more aggressive in seeking recovery of assistance payments, it makes sense to at least try to anticipate the problem with self-amending disability provisions.

ARTICLE ELEVEN: Disability and Asset Protection

A. Wherever used in this instrument the term "disability" means any legal, mental or physical condition which renders a person less than fully able to manage his or her person or estate, or his or her medical, personal or financial affairs.

1. The term shall include, but is not limited to, the stricter standard of "a medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than twelve months"; or, "any condition of comparable severity evidenced by marked functional limitations." Any person who has been determined to be disabled: (i) in the manner provided by Illinois statutes governing adjudication of disability [e.g., Article XIa of the Illinois Probate Act; 755 ILCS 5/11a-1 through 11a-23, or any similar or successor provision governing the same substantive topic]; (ii) for any purpose by the Social Security Administration; and/or, (iii) who has been determined (by any federal or state agency) to be disabled for Medicaid purposes, shall during the term of such determination be deemed to be disabled for the purposes of this instrument. Any person who has suffered a medically determinable condition of such severity as to be sufficient, in the judgement of his or her attending physician or physicians to require his or her institutionalization as a long-term resident of a nursing home or other health care facility, or require long-term nursing or other professional health care on an "in-home" basis, shall during the term of such condition be deemed to be disabled for the purposes of this instrument.

2. To the extent a disability is not established by the findings set forth in Subparagraph A.1. immediately above, then:

a. The determination of a present disability, or the recovery from a past disability, affecting the Grantor or any person who is serving as Trustee shall be made in a signed writing by that person's attending physician after a personal examination. That written determination shall contain: (i) a description of the nature and type of the disability and an assessment of how the disability impacts on the ability of the person to make decisions; (ii) an analysis and results of evaluations of the person's mental and physical condition, and immediately apparent prospects for recovery; (iii) a statement expressing an opinion on whether the person shall require institutionalization as a long-term resident of a nursing home or other health care facility, or require long-term nursing or other professional health care on an "in-home" basis; and, (iv) a conclusion and opinion on whether that person is disabled on the basis of the criteria herein provided. This written determination shall be delivered to the current and successor beneficiaries and, if applicable, to any person nominated as successor Trustee hereunder, who shall then assume the office of Trustee in the manner provided elsewhere in this instrument.

b. The determination of a present disability, or the recovery from a past disability, affecting any beneficiary other than a person who is serving as Trustee hereunder shall be made by the Trustee in his, her, or its sole discretion on the basis of the criteria herein provided and such reasonable inquiry as the Trustee deems appropriate in the circumstances.

B. Notwithstanding anything in this instrument to the contrary, in the event any beneficiary (other than Grantor) suffers a disability then the Trustee's powers, discretions and obligations under this instrument with respect to the disabled beneficiary shall thenceforth, immediately, and without further acts in furtherance be amended, restricted, and governed by the following provisions:

1. In the event that the disabled beneficiary is then serving as Trustee, he or she shall immediately, and for the remaining term of that disability be disqualified to serve as Trustee. This disqualification shall endure through the entire period of disability, but shall end when the disabling condition ends, at which time the beneficiary may be restored as Trustee. The successor Trustee shall be as elsewhere provided in this instrument.

2. Commencing immediately upon the disabling event, the Trustee shall withhold payment of Trust principal or income for basic support requirements such as food, clothing, medical care and shelter which the disabled beneficiary is able to receive from any local, state or federal government agency or agencies or any other source, whether public or private, and the beneficiary's power to withdraw, and the Trustee's discretion to distribute principal from any Trust shall thenceforth be limited accordingly.

3. During such period as the disabled beneficiary is receiving or eligible to receive assistance from local, state or federal government sources, or from private agencies, Trust principal or income shall be distributed to or for the benefit of the disabled beneficiary, if at all, only for the special needs, comforts or luxuries suitable for the beneficiary's happiness (including but not limited to travel, expenses for traveling companions if requested or necessary, entertainment, supplemental medical and dental expenses, social services, and transportation) which will not otherwise be provided by any local, state or federal government agency or agencies, and no distribution shall be made for the basic support and care of the disabled beneficiary.

4. In no event may Trust principal or income be paid to, on the demand of, or for the benefit of any governmental agency or department and the Trustee shall do all things reasonable or necessary to at all times preserve the Trust Estate free of the claims of such governmental bodies.

C. The entitlement, discretion, privilege or interest of any beneficiary to make discretionary withdrawals or to receive distributions of the principal of any Trust Estate during his or her lifetime is contingent upon the these restrictions. The entitlement, discretion, privilege or interest of any beneficiary OTHER THAN THE GRANTOR'S SPOUSE to receive distributions of income from any Trust Estate during his or her lifetime is also contingent upon these restrictions, and any trust income which the Trustee does not distribute pursuant to the foregoing directions and

restrictions shall be added to principal, and the Trustee shall pay currently any fiduciary income taxes accruing on said undistributed income.

D. In the event any proceeding is initiated by any governmental agency to breach, set aside, avoid, or otherwise revise these restrictions on any beneficiary's interest for the purpose of seeking reimbursement from the principal of any Trust Estate for goods, care, or services provided by or at the expense of any governmental body, private agency, or individual, or for any other purpose, then in such event the Trustee's power to distribute principal of the Trust to or for the benefit of the disabled beneficiary at any time during the period of disability shall immediately and without further action by any person terminate, and in such event all provisions for the demand or distribution of principal free of trust to, on account for, or for the benefit of the disabled beneficiary (other than the provision pertaining to termination of the trust in compliance with the Illinois "Rule Against Perpetuities") shall be suspended during the period of disability. If the disability endures until the beneficiary's death, then the beneficiary shall be deemed to have predeceased the date stated for distribution of principal free of trust.

E. Notwithstanding the foregoing, the provisions of this Article are subject to the requirements necessary to preserve the federal and Illinois estate tax marital deduction anticipated elsewhere in this instrument. Those requirements, including the requirement for the annual distribution of the Trust income to Grantor's Spouse, and that no successor beneficiary shall have any right to the principal or income of any Trust created for the exclusive benefit of Grantor's Spouse during the Grantor's Spouse's lifetime, shall supersede these provisions; and, to the extent these provisions are contrary to the requirements of said federal estate tax marital deduction, (but to such extent, only) the same shall, as and with respect to Grantor's Spouse only, be deemed void.

F. Neither the principal nor the income of any Trust Estate (or any beneficial interest in any Trust Estate) shall be liable for or charged with any debts, contracts, liabilities or torts of a beneficiary, or for any duty of support that may or may not be owed by a beneficiary, and no interest in a Trust Estate shall be subject to seizure or other process by any creditor of any beneficiary. No beneficiary shall have the power to compel any discretionary distribution, anticipate, petition for partition, encumber or transfer his or her interest in any Trust Estate in any manner, and any purported anticipation, partition, encumbrance or transfer shall be void *ab initio*. Except in the event of: (i) termination; (ii) a permitted distribution to a beneficiary: or, (iii) as otherwise effectively appointed, no Trustee shall have the power to assign, convey, sell, encumber, hypothecate, pledge, transfer, give, devise, or otherwise dispose of any right, title or interest in or to any portion of the Trust Estate, except for fair value and duly entitled as a substitute asset of the subject Trust Estate, to which all of the provisions of this instrument, and specifically this Article, shall first attach as a condition of such transfer. Nothing in this Article shall limit the lawful exercise of any power of withdrawal retained by Grantor, or the effectiveness of any disclaimer.

F. Administrative Preferences and Additional Authorities

1. Priority of Benefit and Investment Discretion. If the client's beneficial purpose is to provide each current beneficiary maximum latitude in the administration of his or her separate share, subject only to the tax avoidance and asset protection features built into the plan, it may be worth identifying that priority in concrete terms. The following could be a suitable addition to the Trustee's administrative powers.

> **No Trustee shall be liable for any mistake in judgment in the making or retaining of investments, or any other discretionary decision made by the Trustee, so long as any such decision is made in good faith. The Trustee shall have maximum latitude in making investments and shall not be bound by any duty to consider both the reasonable production of income and the preservation of capital value. [Subject to the overriding requirements of the marital deduction provisions provided elsewhere in this instrument,] [and subject further to the limitations to the disposition of "Farm Property" provided elsewhere in this instrument] the Trustee is otherwise specifically authorized to invest the entire Trust Estate: (i) in income producing assets; (ii) in assets selected for the potential of capital growth; (iii) any combination of income and growth investments; or, (iv) assets which neither produce income nor offer potential for capital growth but which the Trustee believes benefit the beneficiary generally. While relying upon the Trustee's fiduciary duties in all other respects as a material term of this Agreement, the Grantor exempts the Trustee from the duties of impartiality in investing with respect to current and successor beneficiaries, it being Grantor's intention to provide maximum benefit to each current beneficiary in priority over the interest of successor beneficiaries. The Trustee may but shall not be required to retain investment advisers, the cost of which shall be borne by the Trust Estate generally. In addition, the Trustee may but is not required to delegate investment functions in any manner consistent with the provisions of the Illinois Trusts and Trustees Act.**

It is hard to imagine a more clear cut grant of individual discretion and priority. Nevertheless, note the bracketed limitations pertaining to the marital deduction requirements, and the possible application of "Farm Property" limitations.

2. No Conflict of Interest: Similar provision can be made to further head off conflict-of-interest issues while addressing the interested trustee tax problems:

> **Any individual acting as Trustee who is also a beneficiary of any Trust or Trust Estate created hereunder may deal with any Trust on an "arms-length" basis without obtaining the approval or confirmation of any Court or any other beneficiary, and such dealings made in good faith shall be as binding and conclusive as though no such relationship or possible conflict of interest existed. Moreover, Grantor acknowledges having been fully informed of the apparent conflict of interests inherent to circumstances when a beneficiary also serves as Trustee, farm tenant, farm manager**

and/or other fiduciary capacity, and having been so fully informed such apparent conflict is freely and knowingly waived, except for harm actually caused by reason of gross negligence or willful malfeasance, it being the Grantor's intention to empower as Trustee, farm tenants, farm managers, and other fiduciaries persons who are members of his/her family and the natural objects of his/her bounty. Any such Trustee shall not be required to account for or disgorge any direct or indirect personal benefit he, she or it receives, or be personally liable for any loss that results, except by reason of gross negligence or willful malfeasance. Any power to make discretionary distributions of Trust principal to or for the benefit of a person who is serving as Trustee of a Trust (including distributions to the person's spouse and distributions in discharge of any legal obligation of the person) or any other discretionary power, the exercise of which could result in distribution of the principal to or for the benefit of such individual, Trustee or Trustees in conjunction with another person having a substantial and adverse interest in that property, and otherwise such power shall not be exercisable; provided, however, that the provisions of this paragraph shall not apply to a power to make distributions which, under this instrument, is limited by an "ascertainable standard" relating to the beneficiary's health, education, support or maintenance as that term is defined and applied by Internal Revenue Code Sections 2511, 2514 and 2041, and supporting regulations.

A second exception to what could otherwise be a taxable general power is allowed when that power may be exercised "only in conjunction with another person" having both a *substantial* and *adverse* interest in the property subject to the power.[39]

3. Compensation: All to often, family members are expected to assume these time-devouring, high-maintenance administrative tasks without pay, and in the end they get about what they pay for. If it is the client's intention to keep the fiduciary fully engaged -- instead of shirking trust work in favor of making a living -- then compensation should be discussed and provided for. Illinois' statutory standard of "reasonable compensation" begs the question of what's fair, so tying the pay to an objective, measurable standard might be preferred. Here's one way:

Each person or entity serving as Trustee shall be entitled to a reasonable compensation for his, her, or its services (which, for each, may be equivalent to but shall not exceed the fees charged by First Trust Bank of Post Oak, Illinois, or its corporate successor, according to its fee schedule published from time to time during the term of the Trust) and to reimbursement for actual, reasonable and necessary expenses incurred on behalf of the Trust.

[39] Code Sections 2514(c)(3)(A) and (B), and Code Sections 2041(b)(1)(C)(i) and (ii).

4. Authority to Continue Farming: If the lengthy "Farm Management" article is not used the following alternative could be added:

The Trustee shall have the power to continue to engage in farm operations and the production, harvesting and marketing of farm products; to participate or decline to participate in governmental agricultural or land programs; to retain farm management consultants or advisors and to engage agents, managers and employees and delegate powers to them; to lease land, equipment or livestock for cash or on shares; to purchase and sell, exchange or otherwise acquire or dispose of farm equipment and farm produce of all kinds; to make improvements, construct, repair, or demolish and remove any buildings, structures or fences; to engage in drainage and conservation programs and to terrace, clear, ditch and drain lands and install irrigation systems; to repair, improve, and construct farm buildings, fences, and drainage facilities; to develop, lease, or otherwise dispose of any mineral, oil, or gas property or rights; to borrow money for any of the purposes described in this paragraph; and in general to do all things customary or desirable in farm operations.

5. Power to Sever Trusts. Essential to addressing the various transfer tax problems is the power to sever trusts on a fractional basis. Illinois has a specific provision for severing trusts "to satisfy *federal* tax requirement[s]"[40], the new Illinois estate tax requires a similar power to sever trusts "to satisfy *Illinois* tax requirements" as well. Until the legislature gets around to applying this patch, the following rewrite of the existing rule could be useful:

The Trustee shall have the power to sever any trust estate on a fractional basis into two or more separate trusts for any reason; to segregate by allocation to a separate account or trust a specific amount or gift made from any trust to reflect a partial disclaimer, to reflect or result in differences in federal or Illinois tax attributes, to satisfy any federal or Illinois tax requirement or election, or to reduce potential generation-skipping transfer tax liability, and income earned on a segregated amount or gift after segregation occurs shall pass to the designated taker of such amount or gift; and to consolidate two or more trusts having substantially similar terms into a single trust. In managing, investing, administering, and distributing the trust property of any separate account or trust and in making applicable tax elections, the Trustee may consider the differences in federal and Illinois tax attributes and all other factors the Trustee believes pertinent and may make disproportionate distributions from the separate trusts or accounts created. A separate account or trust created by severance or segregation shall be treated as a separate trust for all purposes from and after the date on which the severance or segregation is effective, and shall be held on terms and conditions that are substantially equivalent to the

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[40] Section 4.25 of the Trusts and Trustees Act (760 ILCS 5/4.25)

terms of the trust from which it was severed or segregated so that the aggregate interests of each beneficiary in the several trusts are substantially equivalent to the beneficiary's interests in the trust before severance; provided, however, that any terms of the trust before severance that would affect qualification of the trust for any federal or Illinois tax deduction, exclusion, election, exemption, or other special federal or Illinois tax status must remain identical in each of the separate trusts and accounts created.

6. Power to Merge Trusts. The foregoing includes power to consolidate two or more trusts having substantially similar terms into a single trust. There is a great likelihood that upon the death of one or another of the key players two or more trusts of substantially identical beneficial terms -- two substantially similar Descendant's Trusts under Mother and Father's plans, and maybe a parallel ILIT, for example – could be coming together for the benefit of a single beneficiary. Here is a more narrow authority:

The Trustee shall have the power to merge any Trust with any other Trust or trust property held for the benefit of the same beneficiary(ies) (under this or any other instrument) into one single Trust Estate if, in the opinion of the Trustee, the terms and federal transfer tax attributes of such trusts are substantially identical or such a merger can be effected without materially adversely affecting the interests of such beneficiary or beneficiaries.

7. Power to Allot Property. To avoid the administrative headache of fractionalizing property when funding the various trusts, and to take advantage of the latitude afforded by the pecuniary funding formula built into the example, the Trustee should have broad authority to pick and choose assets:

The Trustee shall have the power to allot to any trust an undivided interest in property, make joint investments for two or more trusts hereunder, distribute property in cash or in kind, or partly in each; to allot different kinds or disproportionate shares or undivided interests in property among the distributed shares, without regard to the income tax basis of such property or interest; and, except as specifically required elsewhere in this instrument, to determine the value of any property so allotted or distributed.

8. Tax Elections. This one should be obvious:

The Trustee shall have the power to exercise any discretion, election, or power permitted under any federal or state tax law that the Trustee deems advisable, without regard to its effect on the relative interests of the beneficiaries, and the Trustee shall make no corresponding adjustment between principal and income, or to the relative interests of the beneficiaries to compensate for the effect of the exercise of discretions, elections, or powers.

9. Spendthrift Provisions. These provisions are practically essential if the trust assets are to be insulated from claims:

With respect to each Trust or Trust Estate created by virtue of this instrument, and notwithstanding any provision herein contained to the contrary:

1. Neither the principal nor the income of any interest in a Trust Estate shall be liable for or charged with any debts, contracts, liabilities or torts of a beneficiary, or for any duty of support that may or may not be owed by a beneficiary, and no interest in a Trust Estate shall be subject to seizure or other process by any creditor of a beneficiary.

2. No beneficiary shall have the power to anticipate, petition for partition, encumber or transfer his or her interest in the Trust Estate in any manner, and any purported anticipation, partition, encumbrance or transfer shall be void.

3. No beneficiary shall have any right to compel any discretionary distribution, or to partition any assets held in trust.

4. Nothing in this Paragraph shall limit the lawful exercise of any power of withdrawal retained by Grantor, or the effectiveness of any disclaimer or release.

The substance of this provision is incorporated as part of paragraph F. of the ARTICLE ELEVEN "Disability and Asset Protection" provisions on Page 44 above.

G. Conflict Avoidance and Management.

Naturally, if the interested beneficiary is the sole trustee, conflicts should be at a minimum. But since the biblical confrontation of Cain and Abel the potential for family members to fuss – *seriously* fuss – has proven its way. As one prominent Arizona trial lawyer warned, we are about to see an explosion in the volume and complexity of trusts-and-estates disputes in the near future:

> **Estates are larger and more complex. An "Entitlement Generation" is coming of age. There's been an influx of more litigious probate lawyers as well as a proliferation of poorly drafted and incomplete trusts. Meanwhile, the majority of Americans are without estate plans even as their family trees grow more complicated and their lifespans get longer.**[41]

Failing to make provision for dealing with this potential is almost asking for it.

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Peace, Kenneth J., *A Call to Mediate* July, 2007, TRUSTS AND ESTATES. A thorough examination of the conditions at play.

1. Alternative Dispute Resolution: Starting with mediation can be a good way to provide interested persons an opportunity to voice their concerns, frustrations, and agendas. Sometimes, just letting people express themselves -- and in a process well short of litigation -- can defuse the situation. Mediation is not binding and is not a dispute determinant; rather, the mediator acts as a facilitator among the opposing interests and attempts to help them define issues, find common themes, and accommodate each other to the extent possible while moderating confrontation and calming ill will. Here is one possibility[42]:

> **Any dispute or controversy of every kind or nature arising under or as a result of this instrument shall be referred and submitted to mediation under the auspices of ____________, and no interested person shall have standing to pursue any action at law until that mediation has been completed, although any party may as necessary proceed in equity to preserve status until mediation has been completed.**

This provision may, of course, be followed with arbitration provisions or, in the alternative, a choice of law or venue, and an attorneys' fees clause.

2. Judicial Confirmation: Frequently, an individual trustee may find it advantageous to anticipate trouble by asking the Court in advance to confirm the trust and provide prior authority for actions that could be controversial.

> **No Trustee shall be personally liable upon any contract, note, or other instrument executed hereunder or for any indebtedness of the Trust Estate. To the extent that Grantor may lawfully waive any such requirements, no Trustee shall ever be required to qualify before, be appointed by, or account to any Court, or obtain the order of or approval of any Court in the exercise of any power of discretion herein given. However, the Trustee is hereby specifically authorized to petition the Circuit Court of the County where any one or another Trustee resides to have any Trust herein created confirmed by Order of Court at any time the Trustee determines such confirmation useful in giving effect to this instrument, to resolving uncertainties, or to protecting the Trustee from inappropriate criticism.**

3. In Terrorem: Some courts disapprove of *in terrorem* clauses, as do some states: in Florida they are generally unenforceable, while California has a distinct body of law recognizing and directing their implementation. However that may be, the following clause successfully staved off a court fight merely because the potential antagonists simply

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42 "JAMS" and the American Arbitration Association are both leading voices for alternative dispute resolution methods, and have many representative clauses. www.jamsadr.com and www.adr.org

weren't sure if it was valid, or not, and there was way too much money involved to risk it:

> **Grantor further declares and directs that he/she has created certain preferences for some of his/her children and grandchildren under this agreement that were not extended to others, and that he/she has chosen to exclude some people who might otherwise have had an expectation in his/her property, and the reasons for these decisions are well considered and need not be explained here. However, it is important to Grantor that all his/her children know that these decisions were not made out of any lack of affection or respect for the other children, and that Grantor's love and respect for all of his/her children is equal and immeasurable. It is Grantor's most fervent desire that all of his/her children, and their children, will respect the careful planning represented by this instrument; will cooperate in giving effect to these provisions as cheerfully and willingly as each can; and, will also respect each other's expectations, needs, burdens, and desires over the years to come. The cooperation that each of them extends to the others will demonstrate their appreciation for what Grantor has intended to do for the common benefit of all. Those who choose to cooperate in this manner will be honoring their forebears as well as themselves. Those who choose not to, or who wish in any way to challenge the provisions of this instrument, will be dishonoring their parents or grandparents, and themselves; and, in addition to provoking my eternal condemnation, will be demonstrating themselves unworthy of sharing in the family bounty.**
>
> **Accordingly, and notwithstanding any beneficial terms contained elsewhere in this instrument, if any beneficiary hereunder, whether one or more, institutes or participates in any proceeding to contest or attack the validity of this instrument or any of the terms or provisions hereof, (except as a party defending this instrument) then any beneficial interest provided for that beneficiary or beneficiaries hereunder shall be revoked, and shall pass as if that beneficiary or beneficiaries, and all of his or her or their descendants, had predeceased Grantor. This provision shall apply regardless of whether such proceedings are instituted in good faith or with probable cause. Grantor has been advised that Illinois law sometimes disfavors provisions such as this, and in response respectfully invokes the protection of the Illinois courts and judiciary to construe this provision as broadly as may be possible or necessary to implement Grantor's carefully articulated purpose herein, to-wit: Grantor expects his/her family to abide by his/her wishes and not to fuss, and if they choose to fuss Grantor prays that they take nothing. Amen.**

4. Trust Protectors: At first viewed askance, the notion of an outside advisor and helper is becoming more and more common, especially in the context of these long term trusts[43]. The office first developed to enable settlors of offshore asset protection

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[43] *See*, Romanoff, Robert A., Ch. 6, "Drafting Considerations for Trusts", ADVANCED ASSET PROTECTION PLANNING, Illinois Institute for Continuing Legal Education (Spring, 2007), pp. 46 - 50 for a thorough explanation and comprehensive form. Rob and your author have been singing in chorus on

trusts to continue to influence the control of those assets without exposure to creditors. Whether that worked, or not, the notion has expanded to appointing a domestic trust protector whereby the Grantor is, in effect, vesting one or more limited powers of appointment in a disinterested person who may or may not rise to fiduciary status depending on the drafting and scope of the assignment. Among the powers that can and frequently are delegated are the power:

* To remove or add trustees
* To amend otherwise irrevocable instruments to comply with stated purposes in the light of changed circumstances
* To approve accountings and certain investment recommendations
* To initiate or supervise mediation or arbitration
* Subject to tax considerations, and the Grantor's intent, -- just about anything else

Which seems to raise the problem of -- just who is the trust protector working for? The settlor, or the beneficiaries? Two superb recent articles in the Cardozo Law Review[44] consider whether in empowering the trust protector you are diminishing the trustee, confusing authority, and perhaps merely exchanging one set of fiduciary/agency problems for another. Largely out of that concern, and more largely out of intuitive suspicion, your author has limited his use of trust protectors for select purposes. For example, not long ago the question of identity of potential charitable beneficiaries came up, and the following clause resulted:

> **Grantor hereby confers upon her friend and attorney, WILLIAM A. PEITHMANN, if then living, and if not then living to the then-serving President of the First Trust Bank of Post Oak, Illinois, the limited power of appointment to construe the provisions of this Subparagraph, to give it effect, and to determine the correct identity of each of the above-listed charitable organizations and their respective qualifications under Internal Revenue Section 501(c) as of the date of Grantor's death, which said powerholder may exercise in writing in his or her good faith but absolute discretion, and which shall be binding upon all persons or entities claiming any interest under this instrument.**

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these long term trust issues for more than a decade.

[44] Sterk, Stewart E, *Trust Protectors, Agency Costs and Fiduciary Duty*, 27 CARDOZO LAW REVIEW 2761 (2006); and, Alexander, Gregory S., *Trust Protectors: Who Will Watch the Watchmen?*, 27 CARDOZO LAW REVIEW 2807 (2006).

H. A Comprehensive Powers, Discretions and Limitations Provision

The Illinois Trusts and Trustees Act contains a fine set of empowerments, directions and limitations, but they are generic and sometimes not always as precise as your author would prefer. Plus, it hones our skills to re-read – and sometimes, re-write – these control provisions, and where length and brevity are not a major concern, there is much to be said for writing up your rules afresh. There is some duplication here with provisions provided and explained above:

ARTICLE TWELVE: Trustee's General Powers, Discretions and Limitations.

For the purpose of each Trust and every Trust Estate created under this instrument, and subject always to the foregoing specific provisions pertaining to the administration of this instrument, which specific provisions shall prevail in the event of conflict with this Article:

A. The term "Trustee" as used in this Trust Agreement shall include Co-Trustees when more than one Trustee has been appointed and is acting as such, and shall also include any and all successor Trustees. Except for the right to alter, amend or revoke this Agreement at any time (which right is reserved to the Grantor acting alone in his/her own individual capacity) every title, estate, right and discretion vested in or conferred on the Trustee of any Trust shall likewise become and be vested in, and may be exercised by, any successor Trustee and by a Co-Trustee continuing to act as the sole Trustee of such Trust.

B. Any individual Trustee, by notice in writing to his or her Co-Trustee, may for any period or periods delegate all of his or her powers and duties to his or her Co-Trustee. Any person may rely on the written certification of a Co-Trustee that the Co-Trustee has the power to act without concurrence of any other Trustee.

C. For so long as there is more than one Trustee of a Trust acting under this instrument, a majority of the Trustees may take any action authorized hereby. If the Trustees are evenly divided, and cannot resolve the matter among themselves, then the Trustees shall refer the matter to a Court of competent jurisdiction for resolution. No non-participating or dissenting Trustee shall be liable on account of any action of the participating Trustees.

Compare this judicial referral to the other options for resolving conflicts among the Trustees. In this farming context, sometimes we provide that the Trustee who is engaged in actively farming the land shall have the weighted say.

D. No Trustee acting under this instrument shall be required to give bond for the faithful performance of such Trustee's duties, or have any liability for the acts or omissions to act of any predecessor fiduciary, and in accepting the Trust Estate no Trustee shall have any obligation to audit the accounts of any predecessor fiduciary.

E. Any power to make discretionary distributions of Trust principal to or for the benefit of a person who is serving as Trustee of a Trust (including

distributions to the person's spouse and distributions in discharge of any legal obligation of the person) or any other discretionary power, the exercise of which could result in distribution of the principal to or for the benefit of such individual, shall be exercisable solely by the Trustee or Trustees in conjunction with another person having a substantial and adverse interest in that property, and otherwise such power shall not be exercisable; provided, however, that the provisions of this paragraph shall not apply to a power to make distributions which, under this instrument, is limited by an "ascertainable standard" relating to the beneficiary's health, education, support or maintenance as that term is defined and applied by Internal Revenue Code Sections 2511, 2514 and 2041, and supporting regulations.

F. Each Trustee shall be indemnified by and reimbursed from the Trust Estate for any loss, claim, damage, liability or expense incurred or sustained by such Trustee (including attorney's fees incurred in defense of any such claims), in an individual or fiduciary capacity, by reason of any act or failure to act of such Trustee for or on behalf of or in furtherance of any Trust. However, the protection provided by this Paragraph shall not apply to any loss, damage, liability or expense incurred or sustained by reason of gross negligence or willful malfeasance of any Trustee.

G. No Trustee shall be liable for any loss or depreciation in value sustained by the Trust as a result of the Trustee retaining any property upon which there is later discovered hazardous materials or substances requiring remedial action pursuant to any federal, state, or local environmental law, unless the Trustee contributed to the loss or depreciation in value through gross negligence or willful misconduct.

H. Any individual acting as Trustee who is also a beneficiary of any Trust or Trust Estate created hereunder may deal with any Trust on an "arms-length" basis without obtaining the approval or confirmation of any Court or any other beneficiary, and such dealings made in good faith shall be as binding and conclusive as though no such relationship or possible conflict of interest existed. Moreover, Grantor acknowledges having been fully informed of the apparent conflict of interests inherent to circumstances when a beneficiary also serves as Trustee and/or in other fiduciary capacity, and having been so fully informed such apparent conflict is freely and knowingly waived, except for harm actually caused by reason of gross negligence or willful malfeasance, it being the Grantor's intention to empower as Trustee persons who are members of his/her family and the natural objects of his/her bounty. Any such Trustee shall not be required to account for or disgorge any direct or indirect personal benefit he, she or it receives, or liable for any loss that results, except by reason of gross negligence or willful malfeasance.

I. No Trustee shall be personally liable upon any contract, note, or other instrument executed hereunder or for any indebtedness of the Trust Estate. To the extent that Grantor may legally waive any such requirements, no Trustee shall ever be required to qualify before, be appointed by, or account to any Court, or obtain the order of or approval of any Court in the exercise of any power or discretion herein given. However, the Trustee is hereby authorized to petition the Circuit Court to have any Trust herein created confirmed by Order of Court at any time the Trustee determines such confirmation useful in giving effect to this instrument.

J. Each person or entity serving as Trustee shall be entitled to a reasonable compensation for his, her, or its services, and to reimbursement for expenses incurred on behalf of the Trust.

Reasonableness is in the eye of the beholder. Your author recommends a fixed standard, but rarely succeeds in persuading a client to use it.

K. The Trustee shall render to each adult beneficiary and to the guardian or person having custody of any minor beneficiary having an income interest in a Trust annual or final statements of the transactions of the Trust Estate. Each such beneficiary and/or guardian may approve such accountings with the same force and effect as the final order of a court of competent jurisdiction, and such approval shall be conclusively established unless written objection thereto is delivered to the Trustee within six (6) months after such accountings have been delivered. Except for mandatory distributions specified herein, the Trustee is specifically empowered to make no further distributions from the Trust until such accounting has been approved either by: (i) lapse of time; (ii) the beneficiary or guardian, in writing; or, (iii) a final order of a court of competent jurisdiction.

This provision seems to protect the Trustee more than the beneficiary. Sometimes that is desired, as when a trusted child is appointed to look out for some recalcitrant others and protection is essential to the child's willingness to serve. Other times, more particularly with a corporate Trustee, stricter accounting standards perhaps should apply.

L. Except as otherwise required to preserve the federal and state estate tax marital deduction anticipated elsewhere in this instrument only, income received after the last income payment date, and undistributed at the time any Trust terminates, together with any accrued income, shall be construed as received after the termination and distributed to the next successive income interest.

M. The Trustee shall have full power and authority to do any and all things necessary or proper to manage, control, invest and reinvest the assets constituting a Trust Estate pursuant to the provisions of this instrument and the Illinois Trusts and Trustees Act and Principal and Income Act not inconsistent herewith in the same manner as if the Trustee were the fee simple owner of the Trust Estate. The Trustee's power and authority shall include but not necessarily be limited to the following rights, powers, obligations, duties, authorities, privileges and immunities, any or all of which may be exercised by the Trustee at any time, or from time to time (provided, that except for the power to make tax elections no such power may be exercised in any fashion that might defeat the federal and Illinois estate tax marital deduction eligibility anticipated elsewhere in this instrument), during the term of each Trust and for a reasonable time after its termination as the Trustee determines to be in the best interest of the beneficiaries:

1. To retain any property transferred in trust by Grantor hereunder without liability for any loss, even though the Trustee would not purchase the property as a trust investment and though to retain it might violate sound investment diversification principles.

2. Except as otherwise required to preserve the federal and state estate tax marital deduction anticipated elsewhere in this instrument only, to determine whether any money or other property coming into the hands of the Trustee shall be considered as a part of the principal or income of the Trust Estate, and to apportion between such principal and income any tax, loss or expenditure in connection with the Trust Estate as the Trustee deems just and equitable, including the allocation of all or substantially all taxes or the expenses of administration to income, without regard to the effect on the relative interests of the beneficiaries, and without adjustment to principal or income. Only to the extent the Trustee does not exercise this discretionary power will the allocation between income and principal be governed by the Illinois Principal and Income Act.

Notwithstanding the foregoing, however, if a Trust is the owner or the beneficiary of an individual account in any employee benefit or retirement plan, or any individual retirement or deferred benefit plan, income earned after death in the account shall be income of the Trust. If the Trustee is required to pay all trust income to a beneficiary, the Trustee shall collect and pay the income of the account to the beneficiary in regular installments at least annually (and to the extent that all income cannot be collected from the account, the deficiency shall be paid from the principal of the Trust).

This second paragraph helps qualify this trust as a "designated beneficiary" for deferred benefit plans.

3. Subject to the specific restrictions or instructions contained elsewhere in this instrument, to sell at public or private sale, contract to sell, grant options to buy, convey, transfer, exchange, encumber, or otherwise deal with any trust property (whether real property, personal property, or mixed) and any reinvestments thereof, from time to time or at any time, and for such prices and upon such terms as the Trustee sees fit; to lease or grant easements for a term within or extending beyond the terms of a Trust; and, to repair, improve, remodel, demolish, abandon, partition, or dedicate any real or personal property of a Trust at any time.

4. To borrow money from any lender, including a Trustee individually; to extend or renew any existing indebtedness and to mortgage or pledge trust property; to open accounts, margin or otherwise, with brokerage firms, banks, or others, and to invest the trust property therein; and to conduct, maintain, and operate these accounts for the purchase, sale, and exchange of stocks, bonds, and other securities, and in connection therewith to borrow money, obtain guarantees, and engage in all other activities necessary or incidental to conducting, maintaining, and operating these accounts.

5. Subject only to the specific restrictions or instructions contained elsewhere in this instrument, to retain, buy, sell, exchange, rent and/or lease real estate (which term includes, without limitation, real estate subject to a land trust and all beneficial interests in and powers of direction under any land trust, cooperative unit, condominium association, or time-share arrangement) suitable for use as a personal residence for a beneficiary and to make such property available for the use of the beneficiary without charge or rent. During the term of such investment, the Trustee shall pay the property taxes, assessments, liens, insurance, repairs and other

charges or amounts necessary for the general upkeep and reasonable improvement of the real estate out of principal or income of the Trust Estate containing such property; provided, however, that for so long as the beneficiary actually occupies such property as his or her personal residence, the Trustee shall not be liable for any loss, damage, or other deterioration of such property.

6. To invest and reinvest in any type of real or personal property, including without limitation bonds, common or preferred stocks, partnership interests, limited liability companies, real estate (including real estate subject to a land trust and all beneficial interests in and powers of direction and control under any land trust), bank accounts and certificates of deposits, real estate mortgages, common trust funds, shares of any investment company or other securities (including any bonds, certificates, accounts, common trust funds, or other securities issued by a Trustee or over which a Trustee serves as advisor or manager), art work, collectibles, furniture, jewelry, and automobiles, suitable for use by a beneficiary, and make such property available for the use of the beneficiary without charge or rent; provided, that for so long as the beneficiary has actual possession of such property the Trustee shall not be liable for any loss, damage, or other deterioration of such property.

7. To cause the securities or other property which may comprise the Trust Estate, in whole or in part, to be registered in the name of the Trustee, or in the name of a nominee or nominees without disclosing the Trust, or (in the case of securities) to take and keep the same unregistered and to retain them or any part of them in such manner that they will pass by delivery.

8. To exercise in person or by proxy all voting and other rights, powers, and privileges and take all steps to realize all benefits with respect to stocks or other securities.

9. To exercise all conversion, subscription, voting and other rights of any nature pertaining to any securities or other entitlements in any business or legal entity; to grant proxies, discretionary or otherwise, in respect of such securities; to vote to elect the Trustee or any person affiliated with, employed by or related to the Trustee as an officer or director of any such corporation; to vote to have such corporation employ and pay the Trustee or such person compensation either as an officer, director or employee of such corporation (or in any one or more of such capacities); and to take all actions as the Trustee may consider necessary or desirable in complying with applicable securities laws and regulations.

10. To allot to any trust an undivided interest in property, make joint investments for two or more trusts hereunder, distribute property in cash or in kind, or partly in each; to allot different kinds or disproportionate shares or undivided interests in property among the distributed shares, without regard to the income tax basis of such property or interest; and, except as specifically required elsewhere in this instrument, to determine the value of any property so allotted or distributed.

11. To collect, receive and give acquittances for all income, rent and profits of the Trust Estate, and to contest, compromise or adjust any claims which the Trust Estate, or the Trustee, may assert against others, or which others may assert against the Trust Estate or the Trustee.

12. To pay all expenses incurred in the administration of a Trust, including reasonable compensation to the Trustee, and to employ and pay reasonable compensation to agents and proxies of all types, including but not limited to accountants, attorneys, banks and other financial institutions, and investment advisors, and to delegate to them such powers as the Trustee considers advisable.

13. To establish out of income and credit to principal, in accordance with applicable state law, reasonable reserves for depletion or depreciation, and to maintain an amount of uninvested cash reasonably necessary to provide for future distributions, payments or expenses.

14. To accept by gift, devise, transfer or conveyance additional property, from any source, to be added to and become a part of a Trust Estate, subject to all of the terms and conditions provided in this instrument; and, except as necessary to preserve the federal and state estate tax marital deduction eligibility anticipated elsewhere in this instrument, to disclaim in accordance with applicable state law any power or discretionary obligation afforded the Trustee hereunder with or without the consent of any beneficiary or other interested party, and without corresponding responsibility or liability to any beneficiary or interested person affected thereby even though such disclaimer may adversely affect the interest of one or more of the beneficiaries.

15. To deal with, purchase assets from, or make loans to the fiduciary of any other estate or trust, even though the fiduciary is a Trustee hereunder.

16. To sever any trust estate on a fractional basis into two or more separate trusts for any reason; to segregate by allocation to a separate account or trust a specific amount or gift made from any trust to reflect a partial disclaimer, to reflect or result in differences in federal or Illinois tax attributes, to satisfy any federal or Illinois tax requirement or election, or to reduce potential generation-skipping transfer tax liability, and income earned on a segregated amount or gift after segregation occurs shall pass to the designated taker of such amount or gift; and to consolidate two or more trusts having substantially similar terms into a single trust. In managing, investing, administering, and distributing the trust property of any separate account or trust and in making applicable tax elections, the Trustee may consider the differences in federal and Illinois tax attributes and all other factors the Trustee believes pertinent and may make disproportionate distributions from the separate trusts or accounts created. A separate account or trust created by severance or segregation shall be treated as a separate trust for all purposes from and after the date on which the severance or segregation is effective, and shall be held on terms and conditions that are substantially equivalent to the terms of the trust from which it was severed or segregated so that the aggregate interests of each beneficiary in the several trusts are substantially equivalent to the beneficiary's interests in the trust before severance, provided, however, that any terms of the trust before severance that would

affect qualification of the trust for any federal or Illinois tax deduction, exclusion, election, exemption, or other special federal or Illinois tax status must remain identical in each of the separate trusts and accounts created.

17. Subject only to the specific restrictions or instructions contained elsewhere in this instrument, to pay any and all taxes (including interest and penalties) due from any one or another Trust Estate, and to exercise any discretion, election, or power permitted under the tax laws that the Trustee deems advisable, without regard to its effect on the relative interests of the beneficiaries, and the Trustee shall make no corresponding adjustment between principal and income, or to the relative interests of the beneficiaries to compensate for the effect of the exercise of discretions, elections, or powers, either under the tax laws or under settlement options available for any employee benefit plan or individual retirement account.

18. To collect in any manner the net proceeds of any employee benefit plan, individual retirement account, deferred compensation plan, or life insurance policy, in which case payment to and the receipt of the Trustee shall be a full discharge of the liability of any payor, which need not take notice of this instrument or see to the application of any payment, but the Trustee need not engage in litigation to enforce payment without indemnification satisfactory to it for any resulting expense.

19. To continue to engage in farm operations and the production, harvesting and marketing of farm products; to participate or decline to participate in governmental agricultural or land programs; to retain farm management consultants or advisors and to engage agents, managers and employees and delegate powers to them; to lease land, equipment or livestock for cash or on shares; to purchase and sell, exchange or otherwise acquire or dispose of farm equipment and farm produce of all kinds; to make improvements, construct, repair, or demolish and remove any buildings, structures or fences; to engage in drainage and conservation programs and to terrace, clear, ditch and drain lands and install irrigation systems; to repair, improve, and construct farm buildings, fences, and drainage facilities; to develop, lease, or otherwise dispose of any mineral, oil, or gas property or rights; to borrow money for any of the purposes described in this paragraph; and in general to do all things customary or desirable in farm operations.

20. To do all other acts to accomplish the proper management, investment, and distribution of the Trust not inconsistent with the preceding specific provisions pertaining to the administration of this instrument, which specific provisions shall prevail in the event of conflict with these enumerated provisions.