TRUST ME!

A Discussion of the Many Uses of Trusts for Wealth Transfer Planning

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I. Introduction

Black’s Law Dictionary generally defines a trust as any arrangement whereby property is transferred by someone (the “grantor”) with the intention that it be administered by one party (the “trustee”) for the benefit of another (the “beneficiary”). I like to think of a trust as a vehicle for holding property where the ownership of the property is divided. The trustee holds the legal ownership and control of the property, while the equitable ownership or the benefits from the property belong to one or more beneficiaries.

Trusts are useful for many different purposes. They can be used to manage and safeguard the property gifted to or inherited by minors or other persons who may be unable to manage their own affairs. Trusts are often touted as a way to avoid probate. Trusts can be used to shield property from the creditors of a beneficiary. Many trusts are designed to transfer property in a way that minimizes estate and gift taxes.

This presentation will concentrate on how various trust arrangements are useful in transferring wealth from one generation to another. Initially, I will touch on some of the non-tax uses of trusts, and then I will focus on how different type of trusts can be used to minimize estate/gift taxes.

II. Creation of Trusts

Trusts can be created during a person’s lifetime (inter vivos trusts) or may come into existence at the time of a person’s death (testamentary trusts). When a person creates a trust during their lifetime, they typically enter into a written trust agreement with the trustee and transfer property to the trustee to be held subject to the terms and conditions of the trust agreement. When a person desires to create a testamentary trust, the terms and conditions of the trust are typically included in the person’s last will and testament and property is transferred to the trustee by the personal representative of the grantor’s estate.

A. Intervivos Trusts

Trusts created during the grantor’s lifetime can either be revocable or irrevocable. As the name implies, a revocable trust can be revoked or amended by the grantor at any time. Revocable trusts have become a popular estate planning vehicle for avoiding probate. When a person dies, property that they own individually will normally need to go
through the process of probate, primarily to have a personal representative appointed by a court so that the personal representative can then access and administer the decedent’s property prior to its ultimate distribution. Probate involves the filing of various documents with a probate court, publishing notice for the benefit of potential creditors, and various other administrative formalities which may prove to be somewhat cumbersome and time consuming.

In order to avoid probate, a person can transfer all of their property into a revocable trust so that upon their death there is no individually owned property and no need for a probate administration. The grantor of a revocable trust typically serves as the initial trustee of the revocable trust, and upon their disability or death, the trust agreement will provide for the appointment of a successor trustee. During the grantor’s lifetime, the assets held in a revocable trust remain under the grantor’s control and completely available for the grantor’s use and enjoyment. A revocable trust is essentially the alter ego of the grantor during their lifetime.

For income tax purposes, a revocable trust is transparent. All of the income generated by the property owned by the trust is reported directly on the grantor’s income tax return as if those assets were owned directly by the grantor individually. The revocable trust will also typically use the grantor’s social security number when re-titling assets.

Upon the grantor’s death, the trust becomes irrevocable and acts essentially as a substitute for a last will and testament. The successor trustee does not need to petition a probate court in order to gain access to the property held in trust and is free to administer and distribute the trust property pursuant to the terms of the trust agreement without court oversight or involvement.

The use of a revocable trust to avoid probate sounds attractive and when properly executed can minimize the costs and formalities required when administering and distributing a person’s assets following their death. However, revocable trusts are in many instances over hyped, misused and overpriced. There are many circumstances where individuals have entered into revocable trust agreements and have not followed through in transferring the ownership of their property into the trust. When this occurs it will
still be necessary to probate the person’s estate, as their assets will not be subject to the control of the trustee of the revocable trust until they have gone through the probate process and have been administered and transferred into the trust by a court appointed personal representative.

The grantor may not understand the importance of transferring the ownership of their property into the trust, or may have simply forgotten or overlooked some of their property. Whatever the reason, if a revocable trust is not properly funded, the main purpose of the trust, avoiding probate, will be frustrated. Therefore, prior to entering into a revocable trust agreement it is important to understand the costs involved and be prepared to follow through on properly funding the trust so that the overall plan will work properly.

An individual can also create irrevocable trusts during their lifetime. Once executed, an irrevocable trust cannot be revoked or amended. The primary reason that a trust will be made irrevocable is to create the completed gift for transfer tax purposes. If the grantor can revoke or amend the trust, a completed gift will not have been accomplished.

When an individual desires to give property to another person during their lifetime but is unsure of that person’s ability to manage the property or desires to protect the gifted property from the person’s creditors, it is advisable to use an irrevocable trust to make the gift as opposed to transferring the property to the person outright.

Some of the more popular types of irrevocable trusts agreements will be discussed in more detail later in these materials.

B. Testamentary Trusts

Testamentary trusts are trusts that spring into being at the time of the grantor’s death. A testamentary trust is normally created pursuant to the terms of the grantor’s last will and testament. A testamentary trust can be funded with property from the grantor’s estate or potentially with property, such as life insurance proceeds, which are directed into the trust by a beneficiary designation.

There are both tax and non-tax reasons for creating testamentary trusts. The primary non-tax purpose for creating a testamentary trust is to provide for the management and safeguarding of property that
one desires to leave to a minor or other individual who may not be mature enough to manage their inheritance on their own. If a person leaves property directly to a beneficiary who is a minor, a court-appointed conservatorship will be necessary. A conservatorship involves the appointment of a conservator by a judge and the court’s supervision of the conservator’s actions until the minor reaches the age of majority at which time the property held in the in the conservatorship is distributed outright to the beneficiary. This is a cumbersome, expensive process, and once the beneficiary reaches the age of majority, typically 18, the property they receive is completely theirs to do with what they wish. Therefore, anyone intending on leaving property to minor beneficiaries should create a testamentary trust so that they can choose the person or entity who will act as the trustee to manage the property on behalf of the beneficiary and to designate the ultimate age or ages that the property will be distributed to the beneficiary.

It is my preference that the trustee make all decisions regarding management and distribution of trust property until the beneficiary has reached at least the age of 25. At that age it may be advisable to allow the beneficiary the right to withdraw a certain percentage of the trust property, and it also may be a good idea to allow the beneficiary to become a co-trustee of the trust. I also believe that it is prudent to stage distributions of property to the beneficiary over various ages and percentages as opposed to one distribution of the entire amount of property held by the trust. In this fashion, even if the beneficiary does not make good decisions following the first distribution they will at least have not squandered all of the trust property and hopefully will have learned a valuable lesson that won’t be repeated following subsequent distributions.

Testamentary trusts are also useful for minimizing gift and estate taxes. Transfer taxes will be explored in more depth later in these materials.

III. Taxation of Trusts

A. Income Taxes

If a trust is considered to be a “grantor trust” under Sections 671-678 of the Code, the grantor will be treated as the owner of the trust

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property for income tax purposes and all of the income of the trust will be taxed directly to the grantor. In basic terms, a trust is considered to be a grantor trust if it is revocable, if the grantor has retained the power to control the beneficial enjoyment of the trust property or the income it produces, or if the grantor has retained certain administrative powers.

It is interesting to note that the grantor trust rules for income tax purposes are not consistent with the estate tax transfer provisions requiring inclusion of trust property in the gross estate of the grantor. This gives rise to a planning opportunity whereby an irrevocable trust designed to be outside of the estate of the grantor for estate tax purposes is made “intentionally defective” so that it is a grantor trust for income tax purposes. By doing this, the grantor has retained the obligation to pay the income tax liability attributable to the trust property and will in affect be making ongoing tax free gifts to the beneficiaries of the trust.

When a trust does not qualify as a grantor trust, income taxation will initially depend on whether it is considered to be a “simple” trust or a “complex” trust. A simple trust is a trust where all of the income is required to be distributed currently and no other amounts, such as capital gains, are distributed. The ordinary income of a simple trust is allocated and taxed to the beneficiaries and the capital gains generated by the trust property will generally be taxed at the trust level.

A complex trust is a trust which is not a simple trust. The income and principal of a complex trust may or may not be distributable to the beneficiaries in any year depending upon the terms of the trust and the discretion of the trustee. The basic scheme for the income taxation of a complex trust is to tax the beneficiaries of the trust for the ordinary income of the trust to the extent that distributions of trust income are actually made to the beneficiaries. Generally, the trust itself will be subject to the tax liability for capital gains; however, if capital gains are consistently distributed to a beneficiary, it is possible that the capital gains will be taxed to the beneficiary as opposed to the trust.

This is only a brief overview of the income tax rules relating to trusts. These rules are complicated and a complete discussion of the income taxation of trusts is beyond the scope of these materials.
B. **Estate Taxes**

The transfer of property to a trust during a grantor’s lifetime will result in a completed gift for transfer tax purposes only if the grantor avoids retaining certain rights or powers over the transferred property. These rules are generally set forth in Sections 2036, 2037, and 2038 of the Code.

Section 2036 specifies that a grantor’s gross estate will include the value of all property to the extent that the grantor has retained either the possession or enjoyment of the property, the right to the income from the property, or the right to designate the persons who will possess or enjoy the property or the income therefrom.

Section 2037 provides that a grantor’s estate will include the value of property transferred if possession or enjoyment of the property may only be obtained by an individual if they survive the grantor and where the grantor has retained a reversionary interest in the property the value of which, immediately before his or her death, exceeds 5% of the value of the property.

Section 2038 relates to revocable transfers and provides that a grantor’s estate will include the value of all property transferred by the grantor where the enjoyment thereof was subject to the grantor’s right to alter, amend, revoke, or terminate the transfer.

Generally speaking, transfers to a trust will not be complete for transfer tax purposes if the grantor has retained the right to revoke the trust, the right to receive the income generated by the trust, the right to possess or enjoy trust property, the right to designate the persons who will possess or enjoy trust property or the income therefrom, or the right to potentially have the property revert back to the grantor.

Prior to discussing specific types of trust arrangements, it is important to have a general understanding of the basic federal transfer tax rules. For gift and estate tax purposes, each individual is currently allowed a unified credit amount which allow them to transfer property with up to $2,000,000 without triggering a federal estate tax (the “applicable exclusion amount”). It is also important to understand that $1,000,000 of an individual’s $2,000,000 applicable exclusion amount can be utilized by gifts during a person’s lifetime. This allows a
person to gift up to $1,000,000 of property to others tax-free during their lifetime and transfer property equal in value to their remaining unused applicable exclusion amount tax-free upon their death.

For example, an individual who has gifted $500,000 of their applicable exclusion amount during their lifetime will be able to transfer only $1,500,000 worth of property free from federal estate tax upon their death. Transfers of property beyond the applicable exclusion amount will be taxed at a federal estate tax rate of 45%.

In addition to the applicable exclusion amount, each individual can transfer up to $12,000 per year to as many persons as they would like, free from gift or estate taxes. These annual exclusions are available on a use it or lose it basis each calendar year. It is important to note that gifts qualifying for an annual exclusion must be present interest gifts and not gifts of a future interest in property.

In addition to the $2,000,000 applicable exclusion amount and the $12,000 annual exclusion amounts there is also an unlimited marital deduction from estate taxes. The marital deduction provides that an unlimited amount of lifetime gifts or transfers on death may be made between spouses and not be subject to gift or estate taxes.

Finally, as you are likely aware, lifetime gifts or transfers on death to qualifying charitable organizations are not subject to gift or estate taxes.

IV. Various Types of Trusts

A. Credit Shelter/Bypass Trusts

The combination of individual applicable exclusion amounts and the unlimited marital deduction can create a trap for the unwary. If, on the first death of a husband and wife, all of the couple's wealth is transferred to the surviving spouse there will not be an estate tax due at that point because of the unlimited marital deduction. However, the applicable exclusion amount of the first spouse will have been wasted as all of the couple's wealth will be included in the second spouse's taxable estate and will be sheltered only by the individual applicable exclusion amount of the second spouse.
This can be a costly mistake. As an example, assume that a husband and wife each own $2,000,000 of property. On the husband’s death, he leaves all $2,000,000 directly to his wife. There is no estate tax due on the husband’s death, however, the wife now has a taxable estate of $4,000,000 and upon her death, she will be only able to shelter $2,000,000 of the $4,000,000 of property from estate tax. This leaves an estate tax due on her death of $900,000 (45% times $2,000,000).

A credit shelter or bypass trust is designed to hold property in value equal to the applicable exclusion amount of the first spouse to die keeping this property outside of the surviving spouse’s taxable estate and free from estate taxes on the second death. By utilizing a bypass trust on the first death, a couple can double-up and use both of their individual applicable exclusion amounts to avoid estate taxes. This technique is usually one of the first steps in planning for minimizing transfer taxes.

The bypass trust can be designed so that the surviving spouse is designated as the trustee so that they can control how the property in the bypass trust will be invested. The surviving spouse can also be included as a beneficiary of trust income and principal as long as these distributions are subject to an ascertainable standard such as health, maintenance, education and support.

A bypass trust can either be funded with a set amount (typically pursuant to a formula that will maximize the available exclusion amount on the first death) or, as the applicable exclusion amounts have increased, it is becoming more commonplace for the bypass trust to be funded by virtue of a disclaimer by the surviving spouse. A surviving spouse has nine months following the date of their spouse’s death to disclaim property that they would otherwise inherit. The use of a disclaimer in funding the bypass trust allows for more flexibility when determining how much property should be transferred to the bypass trust, and even whether the bypass trust should be funded at all.

With the applicable exclusion amount set to increase to $3,500,000 on January 1, 2009, a couple that properly utilizes both of their applicable exclusion amounts should be able to pass up to $7,000,000 of property to their descendents free from estate taxes.
B. Qualified Terminable Interest Property Trusts

The unlimited marital deduction represents an important tool to defer or avoid estate taxes for a married couple. Property passing to the surviving spouse under the marital deduction avoids taxation on the death of the first spouse, but becomes part of the surviving spouse’s taxable estate. By combining the use of the applicable exclusion amount with the marital deduction, the estate of the first spouse will pay no estate tax and any potential estate tax will be deferred until the death of the surviving spouse.

The marital deduction is available for property which is left (1) outright to the surviving spouse, (2) in trust for the surviving spouse, if the surviving spouse has the unrestricted right to withdraw any and all of the property during his or her lifetime, or (3) in trust for the surviving spouse, if the trust meets the requirements for a qualified terminable interest property ("QTIP") trust.

In order for a trust to qualify as a QTIP trust the surviving spouse must be entitled to receive all of the trust’s income at least annually, and during the spouse’s lifetime, no one other than the surviving spouse is permitted to receive any trust principal. A proper election must also be made on the first spouse’s estate tax return.

The QTIP trust allows the first spouse to control the ultimate disposition of the QTIP trust property while retaining the benefit of deferring estate taxes until the surviving spouse’s death by virtue of the unlimited marital deduction. QTIP trusts are commonly used in mixed families where there are children from a prior marriage, or when an individual is concerned that their spouse may not be able to protect or manage inherited property.

While it is not a requirement of a QTIP trust that the surviving spouse have any access to the principal of the trust, most QTIP trusts allow distributions from principal to provide for the health, support and maintenance of the surviving spouse, if needed. The surviving spouse can be granted a right to withdraw a certain amount or percentage of the trust principal from time to time as well.

A QTIP trust allows an individual to qualify their property for a marital deduction in order to defer or avoid estate taxes, and at the
same time retain control over the ultimate disposition of the QTIP trust property.

C. Irrevocable Life Insurance Trusts

Many of you are aware that life insurance proceeds generally pass to the designated beneficiaries free from any income tax. It may come as a surprise, however, that the proceeds from a life insurance policy are includable in the taxable estate of the policy owner for estate tax purposes. This could lead to all or a portion of the life insurance proceeds being subject to estate taxes depending on the amount of insurance and the size of the policy owner’s taxable estate.

An irrevocable life insurance trust (“ILIT”) is a trust designed to remove life insurance proceeds from a grantor’s taxable estate usually by taking advantage of the grantor’s available annual gift tax exclusions.

The grantor creates an ILIT by entering into an agreement with a trustee who must be someone other than the grantor. The grantor cannot serve as trustee as the trustee will have certain incidents of ownership over the life insurance policy that could result in the policy proceeds being included in the estate of the grantor, the very thing the ILIT is designed to avoid. The beneficiaries of the ILIT are typically the grantor’s spouse and children.

Once the ILIT has been executed, the grantor will either transfer cash to the ILIT and the trustee will apply for and purchase life insurance on the grantor’s life, or the grantor may transfer the ownership of an existing policy to the ILIT. If the grantor transfers an existing policy to the ILIT, three years must pass before the policy proceeds will be excluded from the grantor’s taxable estate. If the grantor dies within three years of the transfer the policy, the proceeds will be includable in the grantor’s taxable estate.

Once the ILIT owns the life insurance policy, the ILIT itself should be designated as the beneficiary of the life insurance policy. The grantor will typically continue to make gifts to the ILIT which are intended to be used by the trustee to pay the premiums on the life insurance policy as they become due.
Initially gifts to an irrevocable trust do not qualify for the annual gift tax exclusions as they are considered gifts of a future interest as opposed to being gifts of a qualifying present interest. In order for the gifts to the ILIT to qualify for the annual exclusions, the ILIT is drafted to allow the beneficiaries of the trust, typically the grantor’s children, a window of time during which they can withdraw a portion of the contributions to the trust up to the amount of the annual exclusion (currently $12,000 per donee). It is not intended that the beneficiaries will actually withdraw the contributions to the trust, as this would leave the trustee without funds to pay the premiums on the insurance policy, but the withdrawal rights are necessary in order to convert a future interest gift to a present interest gift which qualifies for the annual gift tax exclusion. The trustee of the ILIT should notify the beneficiaries of their right to withdraw contributions to the trust by sending them notices of their right to withdraw contributions on at least an annual basis. These annual notices are sometimes referred to as “Crummey Letters” named after the case which held in favor of using this technique.

Life insurance, by its nature of having premiums paid over time, lends itself to this technique of utilizing annual exclusions to remove the policy proceeds from the grantor’s taxable estate. Gifts to an ILIT by the grantor are typically within the amount of the available annual exclusions and therefore, the insurance proceeds can in most cases be excluded from the grantor’s taxable estate without using up any of the grantor’s applicable exclusion amount.

Anyone who has life insurance that they intend to keep in place for more than a temporary period of time and who has an estate large enough where the life insurance proceeds will be subject to estate taxes should seriously consider creating an ILIT.

D. Grantor Retained Annuity Trusts

A Grantor Retained Annuity Trust ("GRAT") is an irrevocable trust whereby the grantor transfers assets to the trust and retains a right to receive fixed annuity payments, payable at least annually, for a specified term of years. Upon the expiration of the specified term, the remaining assets of the GRAT can be distributed outright to the remainder beneficiaries, such as the grantor’s children, or continued in further trust for the benefit of the remainder beneficiaries.
A GRAT is an estate planning technique based primarily on interest rate assumptions. The value of the initial taxable gift to the GRAT is equal to the fair market value of the property transferred less the present value of the retained annuity interest. The present value of the retained annuity interest is calculated using the assumed rate of return provided in Section 7520 of the Internal Revenue Code of 1986, as amended (the "Code") (the "7520 rate") applicable for the month of the transfer.

The GRAT can be structured so that the present value of the retained annuity is essentially equal to the fair market value of the property transferred and therefore there is little gift tax consequence on the creation of the GRAT. This type of arrangement is often referred to as a "zeroed-out GRAT."

If the property transferred to a zeroed-out GRAT produces a return greater than the assumed 7520 rate there will be excess property remaining in the GRAT at the end of the specified term that will be passed on to the remainder beneficiaries free of gift tax. In the event that the property transferred to a zeroed-out GRAT produces a return that is less than the assumed 7520 rate, the grantor will receive back all of the GRAT property through the annuity payments, and nothing will be left for the benefit of the remainder beneficiaries. In this circumstance, the grantor will not have used up much of his or her estate tax exemption and will be out only the administrative costs of creating and administering the GRAT.

If the grantor dies before the end of the specified term, all of the GRAT assets will be includable in the grantor’s estate, and the estate tax advantages of the GRAT will be lost. Therefore, it is important to choose a specified term for the GRAT that the grantor is likely to outlive.

As an example, assume that a grantor contributes $1 million of property to a GRAT during a month where the 7520 rate is 6%. Under the terms of the GRAT, the grantor is to receive an annual annuity payment of $288,591 for four consecutive years. In this example, the value of the grantor’s retained interest is essentially equal to the value of the assets transferred to the GRAT, and very little applicable exclusion amount is used.
If the GRAT assets in our example produce sufficient earnings to satisfy the four annuity payments, any remaining earnings will be transferred to the remainder beneficiaries without incurring a taxable gift. For example, assume that the GRAT assets enjoy an annual rate of return equal to 15%. At the end of the four year term, $307,963 will remain in the GRAT for the benefit of the remainder beneficiaries.

For federal income tax purposes, a GRAT will be treated as a grantor trust and the income generated during the annuity period will be taxed to the grantor and paid by the grantor with funds outside of the GRAT. Therefore, as long as the pre-tax return on the assets transferred to the GRAT exceeds the 7520 rate, the GRAT will produce a favorable transfer tax result. In addition, if the GRAT were funded with appreciated property which is then used to fulfill the required annuity distributions to the grantor, no taxable gain will be incurred on the distributions.

In summary, a properly structured zeroed-out GRAT funded with property that produces a rate of return in excess of the 7520 rate will allow property of greater value than reported as a taxable gift to pass to the remainder beneficiaries, and in the event that the rate of return of the property transferred to the GRAT does not outperform the 7520 rate little has been lost. Therefore, there is little downside and the upside could create significant estate tax savings.

E. Qualified Personal Residence Trusts

A Qualified Personal Residence Trust (QPRT) is in many respects similar to a GRAT, except a QPRT is required to be funded with a personal residence, and the grantor retains the right to use the residence for a term of years instead of the right to receive annuity payments. This can be very advantageous from a transfer tax perspective, as the value of the personal residence will presumably appreciate during the term of the retained use by the grantor and that, coupled with the initial discount in the value of the gift to the QPRT, creates significant transfer tax leverage.

A QPRT can be funded not only with a grantor’s principal residence, but can also be funded with a secondary residence, such as a vacation
property or cabin. However, a grantor can only create up to two QPRTs.

The initial transfer of a residence to the QPRT is considered to be a gift by the grantor to the remainder beneficiaries. The amount of the gift is calculated by taking the fair market value of the residence and subtracting the assumed value of the grantor’s retained interest. The value of the retained interest is a function of the age of the grantor, the number of years during which the grantor will retain the right to use the residence, the value of the property at the time it is transferred and the 7520 rate for the month the residence is transferred to the QPRT.

By way of illustration, assume that a 55 year old grantor transfers a $1 million residence to a QPRT and retains the right to use and occupy the residence for 10 years. At the end of the 10 year period the residence will be transferred to the grantor’s children. Assuming a 7520 rate of 6% during the month of transfer, the grantor will be deemed to have made a taxable gift of approximately $495,000. However, assuming that the grantor has adequate applicable exclusion amount remaining, there will be no current gift tax payable. Further assuming that the property appreciates at approximately 7% over the 10 year term of the QPRT, the residence will be worth almost $2 million at the time it is transferred to the grantor’s children. The grantor will have transferred property now worth approximately $2 million to his or her children and reported only a $495,000 taxable gift.

Similar to a GRAT, the grantor of a QPRT must outlive the retained interest term or the entire value of the QPRT property will be includable in the grantor’s estate. However, if this were to occur, the estate tax consequences are no worse than if the QPRT had not been created in the first place.

During the retained interest term, the QPRT will qualify as a grantor trust and should the residence be sold during the term, the gain on the sale will qualify for the same income tax benefits associated with owning the residence directly, such as the exclusion from gain under Section 121 of the Code if the residence held by the QPRT is the grantor’s principal residence. However, the residence held by the QPRT may not be sold to the grantor, the grantor’s spouse or an entity controlled by the grantor or the grantor’s spouse. In addition, if the
proceeds from the sale of the residence are not reinvested into a new residence, the QPRT must begin paying an annual annuity to the grantor calculated based on the Section 7520 rate.

In summary, a QPRT can be a valuable tool to reduce the size of a potentially taxable estate by creating a substantial reduction in the gift tax value of the transfer.

F. Generation Skipping Trusts

The estate tax typically applies only to property owned by an individual or property over which the individual holds a general power of appointment. In simple terms, a general power of appointment is a right held by an individual to convert the property subject to the general power of appointment to their own individual ownership. The estate tax does not typically apply to property gifted to an individual by another party in which the individual has the right to receive income or the right to receive principal, as long as the right to receive principal is subject to an ascertainable standard such as health, support, education and maintenance.

Therefore, in order to avoid repeated exposure to estate tax liability at each generation as property passes from generation to generation estate planners have utilized Generation Skipping Trusts ("GSTs"). GSTs continue beyond the lifetimes of one or more generations in order to avoid having the estate tax erode family wealth on those generations.

For example, a grantor can create a GST either during their lifetime or upon their death such that the property stays in trust initially for the benefit of their child during the child’s entire lifetime, with income and principal payable to the child as necessary for the child’s health, support, education and maintenance. The grantor can also give the child a limited power of appointment over the GST property whereby the child can appoint the property to whoever the child desires either during their lifetime or upon their death, as long as the power of appointment cannot be exercised in favor of the child, the child’s creditors, the child’s estate, or the creditors of the child’s estate. The child can even serve as the trustee of the GST, as long as the trust is carefully drafted to insure that the child does not hold any powers as
trustee that would force the inclusion of the trust property in the child’s taxable estate.

Using this type of GST, the child can receive the benefits from the GST property if needed for their health, support, education or maintenance, and the child can control who will receive the future benefits or ownership of the GST property. Additionally, as trustee the child can control how the GST property is invested. All of this is accomplished without having the GST property included in the child’s taxable estate and subject to estate taxes at the time of the child’s death.

There are limits to the amount of property that can skip a generation. In 1986, Congress enacted a generation skipping tax that applies to GSTs or other direct gifts where one or more generations are skipped. Currently the GST exemption is equal to the amount of the applicable exclusion amount, or $2 million.

Assuming that the size of the applicable exclusion amount continues to increase, GSTs will likely be used less frequently; however, for families owning significant wealth, GSTs will remain an important part of their overall estate planning.

G. Charitable Trusts

1) Charitable Remainder Trusts

A charitable remainder trust ("CRT") is an irrevocable trust that pays an annual amount to a non-charitable beneficiary or beneficiaries for a period of time, measured either by the beneficiary’s life or over a specified term. At the end of the lifetime or specified term, the trust property is then transferred to one or more charities. A CRT can be established during the lifetime of the grantor or upon the death of the grantor. If the grantor creates a CRT during his or her lifetime, the grantor will receive an income tax deduction, and the CRT itself will be treated as a tax exempt entity.

While the income and capital gains generated by property held in the CRT will not be taxed to the CRT, it must be accounted for and when distributions are made to the non-charitable beneficiaries, the beneficiaries will receive allocations of trust
income and/or capital gains to the extent of the distributions that they receive.

There are two basic types of CRTs. A charitable remainder annuity trust ("CRAT") is a CRT that pays a specific amount annually to the non-charitable beneficiary or beneficiaries either for life or a specified term of years. The amount of the annuity payment does not change over time. A charitable remainder unitrust ("CRUT") pays the non-charitable beneficiary or beneficiaries a percentage of the value of the CRUT property each year. The percentage is set upon the creation of the trust and does not change. However, as the value of the trust property changes over time, the payments to the non-charitable beneficiaries will correspondingly increase or decrease depending on the value of the CRUT property from year to year.

The income tax deduction to the grantor upon the creation of an inter vivos CRT is calculated based on the fair market value of the property transferred to the CRT reduced by the estimated present value of the annual payments to be made to the non-charitable beneficiaries based on the life expectancies of the beneficiaries and utilizing the 7520 rate. The present value of the charitable remainder interest must be at least 10% of the initial fair market value of the property contributed to the CRT.

CRTs are often used in order to allow a grantor to diversify appreciated property without incurring a capital gain tax. The appreciated property is contributed to the CRT, and following the contribution, the CRT is able to sell the property without incurring a capital gains tax. However, once the CRT begins making distributions to the non-charitable beneficiaries, the non-charitable beneficiaries will recognize the ordinary income and capital gains previously avoided by the CRT, but only to the extent of the distributions they receive. Therefore, to the extent distributions are made to the non-charitable beneficiaries, the income and gains of the trust are deferred until the distributions are actually made; and to the extent that the income and gains of the CRT are not distributed to the non-charitable beneficiaries, the tax on that portion of the CRTs income and capital gains will be avoided.
Even though the CRT is an irrevocable trust, the grantor can retain the power to change the charitable beneficiaries, and the power to change the trustee.

For those individuals who have a charitable intent and own appreciated property, a CRT can be a useful technique to minimize their capital gains and fulfill their charitable intentions.

2) **Charitable Lead Trusts**

Charitable Lead Trusts ("CLT") are often viewed as the opposite of a charitable remainder trust. The grantor transfers property to the CLT, which makes annual payments to a charity (either fixed amounts or a fixed percentage of the trust property annually for a specified period of time). At the end of the specified term, the remaining trust property is distributed to the remainder beneficiaries of the trust, typically the grantor’s children or grandchildren. A CLT can be created either during the grantor’s lifetime or at the time of the grantor’s death.

There is no income tax deduction available to the grantor upon the creation of the CLT, however, the grantor will be allowed a gift or estate tax charitable deduction for the present value of the annual payments to be made to the charity. Unlike a charitable remainder trust, a CLT is not exempt from income tax, and will be required to pay income taxes if its income exceeds its distributions to charity in any given year.

Generally, a CLT is useful to fulfill a grantor’s charitable intent and obtain a discount on the transfer that will ultimately go to the remainder beneficiaries. Transfer tax costs are minimized primarily because any appreciation in the value of the CLT property subsequent to the creation of the trust is not subject to gift or estate taxes. It is also possible to leverage the use of the grantor’s generation skipping transfer tax exemption by naming grandchildren as the remainder beneficiaries of the CLT.

CLTs tend to be most popular during times of low interest rates, because the lower the interest rates used in calculating the value
of the charitable interests, the greater the value of the charitable interest becomes, thereby reducing the amount of the transfer.

V. Conclusion

There are many types of trusts designed to accomplish different goals. Some of these goals relate to the reduction of income and transfer taxes, and some of these goals are completely unrelated to taxes. Trusts are often complicated and misunderstood. Hopefully this summary of the basic rules governing the creation and taxation of trusts, and the descriptions of how some of the more common trusts are utilized will be helpful in designing wealth transfer plans for you and your clients.