Chapter 7: Taxation of Trusts

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THE CREATION AND OPERATION OF TRUSTS

PURPOSE OF TRUSTS

The sole purpose of a trust is to transfer property. Eventually, everyone must transfer their property to someone else.[1] Property can be transferred either outright or in trust. Outright transfers are the most straightforward, but provide the transferor with no means to control how the transferee will use the property. By transferring property to a trust, the transferor retains control over how the property will be managed and used after the transfer when the transferor no longer owns the property.

When the property owner decides to establish a trust to accomplish the desired transfer, the owner transfers property interests to the trust, which then owns, manages, and distributes the property in accordance with the provisions of the trust document. The trust's creator is given great flexibility in establishing how the trust will operate and how distributions will be made. Until the trust terminates, the trust's provisions will control the management and distribution of the property owned by the entity. Trusts allow the transferor to dictate how the transferees will enjoy the property while retaining control over how and when the property is used.

KEY LEGAL PROVISIONS

Property Transfers

State law determines if property has been transferred. It is important to remember that a trust exists only when state law deems a completed trust transfer has occurred. Before a trust is established, some property must be retitled in the trust's name. The professional must first determine when the property was transferred, how the property was transferred, and which state's law will control the transfer. State law must always be reviewed to determine the extent to which property has been transferred and what property interests are considered transferred.

Property can be transferred in one of two ways:

1. Sale
2. Gift

Under state law, **a sale** occurs when the **owner transfers property to another in exchange for some form of consideration.** Individuals can sell property to a trust, since most trustees are empowered to buy and sell property on behalf of the trust. For tax purposes, the consideration received and the property's basis at the time of the exchange determines if a gain or loss is realized on the transfer.

Gifts are different. Under property law, there are **four requirements for a valid gift:**

1. The owner must be capable of making a gift.
2. The transferee must be able to receive the property.
3. There must be delivery and acceptance.
4. The owner must intend to make a gift, which is evidenced by the owner not receiving any form of consideration or receiving inadequate consideration.

Generally, state law is used to determine if a transfer has occurred for tax purposes. In the gift area, there is a distinction made between taxable gifts for **income** and **transfer** tax purposes. For the purposes of this discussion, transfer taxes include: federal estate and gift taxes.

Under **transfer** tax provisions, **intent is normally ignored** and the **value of consideration in comparison to the value of property transferred is used** to determine the nature of the transaction. If the value of the property transferred is greater than the value of the consideration received, the value of the transferred property in excess of the consideration is a gift subject to taxation.

For income tax purposes, **intent** is used to determine if the transfer was or was not a gift. If the transferor intended to make a gift, the transferee has no income taxable event, but if no gift was intended, the transferee has potential taxable income.

Example 1. Don is 80 years old. He employs Donna, who is 30 years old, to assist him at his residence. Don pays Donna an annual salary of $65,000, on which he properly reports all payroll taxes. During the year, Don transfers a new $45,000 Lexus to Donna.

If Don **intended** to make a gift, Donna has **no income.** If Don **did not intend** a gift, Donna has **taxable income of $45,000.**

The taxability of Don's gift depends on whether the value of Donna's service is $110,000. To the extent the value of Donna's service is less than $110,000, Don has made a gift subject to gift tax.

The taxation of a transfer to the trust will take the form of a sale or gift. **If it is a sale,** the **income tax laws will control** both the initial transfer and the subsequent transfers to the beneficiaries. **If it is a gift,** the **transfer tax laws determine the taxation of the initial transfer,** while the **income tax laws determine how the benefits are taxed.** In most situations, property transferred to a trust is a gift.

A trust is used when the owner wants to transfer property to certain individuals; however, the desired transferees are unable to or incapable of receiving the property outright. There exist three incapacities that prevent a transferee from receiving property outright. In order for a transferor to transfer the benefits of property to the incapacitated beneficiary, the owner must use a trust.

The three incapacities are:

1. Legal,
2. Mental, and
3. Financial.

The first two are regulated by state law, and the third is based on the transferor's opinion of the transferee's financial management skills. While outright transfers are less costly, a trust is the only way to provide the transferor with assurance that the property will be used in a manner desired by the transferor.

Timing of Transfers

A transfer can occur during life or at death. **Lifetime transfers** are called **inter vivos transfers** and **death transfers** are called **testamentary** transfers. **Estates** are concerned with **testamentary transfers only. Trust transfers** can be **either inter vivos or testamentary.**

Testamentary transfers must comply with specific legal provisions or they will not be effective. Since the owner of the property is dead, the law requires the extra provisions to assure that the deceased owner's wishes are properly carried out and that the wishes reflected in the document are truly those of the deceased owner.

Terms Used to Describe Parties

Various names given to parties of different fiduciary transactions can be one of the more confusing things in estate planning. Specific names are used to identify particular transaction types. Under English law, labels were used to identify the transaction, and if the appropriate name was not used, the transaction was void or voidable. It is important to use the correct names, so everyone knows exactly what type of transaction is being recorded.

There are always **three** parties involved in fiduciary transactions.

Types of Fiduciary Transactions	Original Owner or Transferor	Manager of Property or the Fiduciary	Person Entitled to Benefits or Transferee
Trust	Grantor	Trustee	Beneficiary
Estate with a will	Testator	Executor	Beneficiary or heir
Estate without a will	Deceased	Administrator	Heir

Property Ownership Transferred

The division of property ownership is critical to the operation of a fiduciary entity. Unlike a fee simple, where the owner owns every interest in the property, in a fiduciary setting, different parties own various interests. The same person or many individuals can own these property interests. Understanding the differing interests is important to proper trust operation and reporting.

Types of Ownership

Legal ownership means the right to title. The legal interest owner is able to manage and control the property.

Beneficial ownership is enjoyed by the person who is entitled to the economic interests in the property. Economic benefits from property take two forms:

1. Income
2. Appreciation

Tax code is primarily concerned with ownership of beneficial title; therefore, the owner of any beneficial interest is normally the party responsible for any taxes. The division between income and appreciation interest owners is accounted for in the entity's books. The trustee is responsible to both sets of owners, whose rights and benefits vary depending on how the trust is managed.

Types of Beneficiaries

The **income beneficiary** is the owner of the trust's beneficial income interest. This party is entitled to the trust's accounting income during the term of ownership.

Since the income beneficiary's ownership interest is allowed for a specific period of time only, that period of time is referred to as a **"term."** The I.R.C makes various references to a **term interest.** A term interest is an income interest limited by a period of time. Also, the trustee may be **required to distribute all or a portion** of the accounting income each year or the trustee may be **given the discretion whether or not to distribute any** accounting income. If the **trustee is required to make income distributions,** the income beneficiary is stated to own a **mandatory income interest.** Otherwise, the income beneficiary is stated to own a **discretionary income interest.**

The most common term interests are:

- Life estate, and
- Interest for years.

The **length of a life estate** is based on a **measuring life.** The measuring life can be either the current interest owner or someone else. When the measuring life dies, the income interest ends. When the life estate ends, the income interest merges with the appreciation interest and passes to the appreciation interest holder. An **interest for years** is based on the specific time period named in the transferring document. The most common example of an interest for years is an office lease. At the end of the lease, the tenant must either move or sign a new lease. The tenant's ownership enables them to enjoy the property during the term, but once the term ends, all rights to the property cease.

The **remainder beneficiary** is the owner of beneficial appreciation interest which is called the remainder. If the original owner owns the remainder, the original owner is deemed to own a **reversion.** Unlike an income interest, the party who will receive the property at the end of the income interest is not fully known until the income interest actually ends. When the appreciation interest owner's right is delayed by time only, the owner is considered to own a **vested** interest; however, if the right is not only delayed by time, but the occurrence of a future event, the owner has a **contingent** interest.

> **Example 2.** Harold transfers property to a trust for the benefit of his two children, Sam and Sally. At their deaths, the trust terminates and the remainder is transferred to Harold's grandchildren. **Sam and Sally own an income interest** in the trust, while the **grandchildren own a vested future interest** in the trust.
>
> If Harold required the grandchildren to survive Sam and Sally before they became entitled to any of the remainder, then the grandchildren would own a **contingent future interest.**
>
> In both cases, the grandchildren must wait for Sam and Sally to die before they receive any of the property; however, in the second case, unless they actually survive Sam and Sally, neither they nor their estates will receive any of the property.

A person owns a **present** interest when he is entitled to currently enjoy the property or income from the property. A **future** interest is owned when the property rights are delayed by time and/or an event. When a trust is created, a beneficiary's interest will either be present or future. The trustee will always have a present interest in the legal ownership.

An **income beneficiary has a present interest** when the trustee is **required to distribute** some or all of its income annually. If the trustee has **discretion** as to whether some or all of the income is distributed, the **income beneficiary has a future interest** in the trust.

A **remainder beneficiary** always has a **future interest.**

The **annual exclusion for gift tax purposes** can be taken for gifts of a **present interest** only.

Simple Trust. A trust may qualify as a simple trust if the trust instrument:

- Requires that all income must be distributed currently,
- Does not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes, and
- Does not distribute amounts allocated to the corpus of the trust.

Complex Trust. A trust is a complex trust if it does not qualify as a simple trust, as explained previously.

CREATING A TRUST

Trusts are formed and regulated by state law. Each state has its own statutes concerning trusts. While these statutes are fairly uniform, it is important to review the trust laws in the state where the trust operates. Only one state's laws govern a trust's formation and operations. There are six basic elements required in establishing a trust.

1. Intention to Create a Trust

A trust is created only if the grantor signifies an intention to create a trust. Determining intent is a question of fact. Courts do not create a trust unless the grantor has expressed the desire that the transfer be in the form of a trust. Generally the language of the trust document is used to determine if the grantor intended a trust.

2. Trustee

The main purpose of a trust is to ensure property is managed during the beneficiary's incapacity. The manager is referred to as the trustee. Without the division of legal and beneficial ownership, a trust cannot exist. Before a person can be **appointed trustee,** the person must have the **legal ability to take, hold, and transfer trust property,** and if the trustee is a corporation, the **corporation must be able to act as a trustee in the state** where the trust is formed.

The **grantor** or a **beneficiary** can be named as the **trustee,** provided all of the legal and beneficial interests conveyed into the trust are not held by a single person. In addition, the **trustee must accept the appointment.** No one can be forced to serve as a trustee. If the grantor has failed to name an alternate, the court will appoint a replacement trustee.

3. One or More Beneficiaries

Restrictions that apply to legal ownership do not apply to beneficial ownership; therefore, **anyone can be a beneficiary.** In naming the beneficiaries of a trust, it is important to designate them with sufficient clarity and certainty to be capable of identification, although not necessarily by name. Unless the beneficiary can be identified, the trust will fail. **Only the grantor can name beneficiaries.**

> **Example 3.** Arthur establishes a trust, naming his children as income beneficiaries and grandchildren as remainder beneficiaries. This would be a valid trust, since Art's children and grandchildren can be identified.
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> If Art had established a trust naming his friends as beneficiaries, a valid trust would not exist, since identifying exactly who Art's friends are would be impossible.

Every interest in property must be owned by some living person or entity at all times. The beneficiary must be alive when it is time to take possession of the property; therefore, present interest owners must be alive when their interests are created and future interest owners must be alive when the current interest ends.

Whenever a trust is established, the beneficiary is presumed to accept the benefits. The beneficiary is not obligated to become a beneficiary; therefore, if the beneficiary properly disclaims the trust benefits, the beneficiary will be treated as having never been a beneficiary.

4. Specific Property Placed in Trust

Before a trust actually exists, the grantor must divest himself of some property and transfer it into the trust. The **trust must own the legal title** and the **beneficiary must own beneficial title.**

When the property is transferred to the trust, the trust is considered funded. Until it is funded, the trust does not exist. Merely signing a piece of paper does not create a valid trust. Unless prohibited by the trust document, the grantor can add additional property to the trust at any time during its existence. Property placed in trust is called the **corpus** or **principal.**

5. Meet Written Requirements

A trust is valid only if there is written evidence of the trust's terms signed by the grantor. This applies regardless of the type of property transferred to the trust. A trust cannot be established for illegal purposes. The grantor can reserve certain interests and powers over the trust. All reserved powers must be spelled out in the trust document.

The trust document controls the operations of the trust; therefore, by requiring a written document, state law forces the grantor to determine exactly how the trust shall operate. The grantor has total control over how the trust operates. Since many accounting and tax actions are based solely on the trust document, a written document is a practical requirement.

6. Must Terminate or Fail

The law does not favor split interests. At some point in time, all interests in property must reunite and form a fee simple.

The Rule against Perpetuities was enacted to void a trust if the document fails to provide for a proper termination. The Rule applies to all trusts, except for those that have charitable beneficiaries. In practice, the Rule will void a trust unless the beneficial interest vests, if at all, within 21 years after the death of a beneficiary, who was alive at the moment the property was transferred into an irrevocable trust. The Rule is not favored in many states; therefore, the courts have the power to reform or construct the trust to avoid the impact of the Rule. Some states follow the doctrine of *cy-pres*, which allows the court to construct the trust to best represent the intent of the grantor. The best way to avoid the Rule is for the grantor to designate a specific time for the trust to end. All trusts must end, so it is best if the grantor determines when this occurs. Some states have repealed the Rule allowing a trust to exist perpetually.

OPERATIONAL SIMILARITIES OF TRUSTS AND ESTATES

The significant difference between trusts and estates is their duration. The life of an estate is shorter than the life of a trust. An estate exists until all of the assets have been collected and all of the debts paid and is then terminated on distribution of the probate estate. A trust exists until the beneficiary's interest ends or the trust terminates.

Trusts and probate estates are overall very similar in operation. Both entities are concerned with the transfer of property from the transferor to the transferee, with the fiduciary managing the property until certain defined events are concluded. Each entity comes into existence at a specific time and both must end once all property has been properly transferred. Both are separate legal entities. Both are able to own, buy, and sell property.

The transferor creates both entities. The transferor has a great amount of flexibility in how each entity is to operate and the powers/duties of the fiduciary. If the transferor fails to make appropriate provision for a particular event in the creating document, state law will fill in the missing information.

The fiduciary has a legal responsibility to manage the entity for the sole benefit of the beneficiaries. More than one party can be a current fiduciary. While the entity exists, the fiduciary is prohibited from undertaking an activity that would be adverse to the beneficiaries or create a conflict between the beneficiaries and the fiduciary.

The fiduciary is responsible for filing all legal documents, protecting the property, and collecting all income and paying all debts associated with the property. The document and then state law will determine how the entity operates. The fiduciary has a duty to treat all beneficiaries equally, unless the document provides for unequal treatment. The interests of the income and appreciation interest owners are mutually exclusive; therefore, the equitable treatment of the beneficiaries forms the basis of fiduciary accounting.

ACCOUNTING FOR A TRUST

Trust accounting is **not** financial accounting. Many of the rules and designations that apply to financial accounting have no relevance when preparing the records of a trust. The purpose of trust accounting is to determine how much is available to be distributed to the beneficiaries and whether the trustee has properly discharged all applicable duties.

The key to successfully completing a trust income tax return is based on having a correct computation of accounting income. Trusts and estates are taxed like individuals, with certain modifications. The main goal of Subchapter J of Subtitle A of the Internal Revenue Code is to allocate taxable income to the proper parties. This allocation is rooted in accounting income.

TYPES OF TRUST ACCOUNTING

There are **two** types of trust accounting:

1. Performance
2. Discharge

Performance accounting focuses on the **investment performance** of the assets under the trustee's control. The trustee is responsible for the proper management of the assets; therefore, by determining the return on the assets, the trustee can decide how productive her investment decisions have been and if changes need to be made.

Discharge accounting has a different slant. The trustee is accountable to the beneficiaries. It is the trustee's responsibility to manage the entity's assets so the wishes of the grantor can be achieved and the beneficiaries can receive an adequate return. Since the trustee is managing someone else's property, she is subject to a high standard of care. The question becomes, "How well has the trustee discharged her duty to the beneficiaries?" Discharge accounting answers this question. Eventually the entity must be terminated. When termination occurs, the trustee will be released from any future liability toward the beneficiaries. Through discharge accounting principles, it can be determined if the trustee has properly handled the affairs of the trust and should be discharged.

The primary focus of this section is on discharge accounting. While performance accounting is important, many of the performance issues can be answered through discharge accounting. Furthermore, every trust can be different. Since the grantor has a great amount of flexibility in establishing the operation of the entity, trust accounting must be able to adapt to this flexibility. Unlike financial accounting, where the goal is to provide statements that provide investors and creditors with the ability to compare businesses, trust accounting is not concerned with comparing the operations of two or more trusts. The only question is, "Did the trustee properly discharge her responsibilities toward this particular trust?" In preparing the accounting records, the three main questions are:

1. Did the trustee comply with the terms of the governing document?
2. Did the trustee comply with state law?
3. Did the trustee treat all beneficiaries in a fair and equitable manner?

If the answer to all three questions is "Yes," the trustee should be released from liability and the trust closed.

DISCHARGE ACCOUNTING

Purpose of Discharge Accounting

The purpose of discharge accounting is to determine if the trustee properly discharged her responsibilities to the trust's beneficiaries. Since the beneficiaries' interests are mutually exclusive, the trustee must walk a fine line between the opposing forces. The records must show that the trustee complied with the terms of the governing document and did not abuse her discretion by favoring an individual or class of beneficiaries over another individual or group. There are two types of beneficiaries associated with a fiduciary entity:

1. Income beneficiaries — income interest owners
2. Remainder beneficiaries — appreciation interest owners

If a trustee distributes property to the income beneficiaries, there is less property available for future distributions to the remainder beneficiaries. The reverse holds true if the trustee accumulates property for future distributions.

The proper allocation of inflows and outflows between the two groups of beneficiaries is the primary function of the trustee. It is this allocation where the trustee demonstrates her management of the entity. Failing to correctly allocate property between the rival groups could result in trustee liability. Furthermore, it is this allocation that determines which party bears the tax liability.

Lack of Accounting Principles

Unlike financial accounting, trust accounting does not have a broad base of principles. There exist very few courses or books on how to prepare a set of trust accounting records. As previously discussed, this is due to the varying nature of each trust and the purpose of discharge accounting.

The goal of the accounting records is to determine the allocation of inflows and outflows between the various beneficiaries and to determine compliance with the governing document. The flexibility given the transferor in creating the trust's terms requires that the associated accounting principles be adaptable to each individual trust. Strict rules do not apply, since different rules or definitions may be needed to determine if the trustee has discharged her responsibilities to the particular trust. While this is frustrating to the accountant, it is one of the unique characteristics of trust accounting.

Key Concepts of Trust Accounting

Two major sets of principles have been adopted concerning trust accounting:

1. Uniform Fiduciary Accounting Principles and Model Account Formats
2. Uniform Principal and Income Act[2]

The purpose of the Uniform Principal and Income Act (UPIA) is to properly allocate inflows and outflows between the beneficiaries. The purpose of Uniform Fiduciary Accounting Principles and Model Account Formats is to have some uniformity in how the accounting records should be prepared. The objectives of these principles are to provide:

- Maximum clarity,
- Full disclosure, and
- Complete description and explanation of all events.

The end result should be reports that protect the appropriate parties, while permitting flexibility based on the circumstances and environmental changes. Not all trust accounts will be identical, and the accountant is not forced to use any particular format. If the reports provide the reader with the ability to determine if the trustee has adequately discharged her responsibilities toward the entity, the reports are correct. A great amount of professional judgment is required in preparing a trust's records.

ALLOCATION BETWEEN CORPUS AND INCOME[3]

INTRODUCTION

There is a major difference between trust and financial accounting when recording actual transactions. The **assets** given to the trustee comprise the **corpus** or **principal** of the entity. It is the trustee's responsibility to manage the corpus for the benefit of the beneficiaries.

During the accounting period, various inflows and outflows are incurred by the trustee. Some of these items will be treated for trust accounting purposes as **corpus items,** increasing or decreasing the amount of assets available for the ultimate use of the beneficiaries. Other items will be designated as **income.**

The main purpose for allocating between **income** and **corpus** is to allocate inflows and outflows between the appropriate beneficiaries properly:

- **Income beneficiaries** are entitled to the **income** from the entity.
- **Remainder beneficiaries** are entitled to **corpus.**

Although a majority of accountants would record most inflows as income, this treatment would adversely affect the remainder beneficiaries. Further, recording all outflows as expense would adversely affect the income beneficiaries. Therefore, a system has been developed to protect the interests of both beneficiaries by allocating the inflows and outflows between income and corpus to determine the correct amounts available to the particular beneficiaries.

No generally accepted accounting principles that cover trust accounting exist. Unlike financial accounting, trust accounting must rely on the trust's creating document and state law. The UPIA was drafted to determine what amounts should be allocated between income and corpus.

GENERAL PROVISIONS

The first place to start for determining the trust's accounting income is the trust document. Section 103 of the 1997 UPIA states:

(a) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:

1. *shall administer a trust or estate in accordance with the terms of the trust or will, even if there is a different provision in this [Act];*
2. *may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by the [Act];*
3. *shall administer a trust or estate in accordance with this [Act] if the terms of the trust or will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and*
4. *shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.*

(b) In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

The grantor has a tremendous flexibility in determining how the income from the trust will be calculated. When creating the trust, the grantor is allowed to state what items shall be attributed to income beneficiaries and what amounts should be retained for remainder beneficiaries. The reason for this latitude is to provide the grantor with the ultimate responsibility for determining what property should go to which beneficiary.

If the grantor wants every inflow to increase income and every outflow to reduce corpus, then his wishes should be followed. The intent of the grantor is paramount in the allocation of items between income and corpus. Due to the flexibility given the grantor, various items that are income/expense under financial accounting are not so under trust accounting.

Section 103(b) states that the grantor can give the trustee discretion in determining what amounts are allocated to income and corpus; however, the trustee's discretion is not as broad as that of the grantor. Under §103(b) of the 1997 UPIA, when discretion is given in the trust document, the trustee must use reasonable discretion in her allocations, basing them on the intent of the grantor when construing the entire trust instrument aided by the surrounding circumstances. Use of the words "absolute" or "full" does not alter the trustee's responsibility, since she is bound by a duty of impartiality. Courts may interfere with the trustee's discretionary power in the event of fraud, misconduct, or a clear abuse of discretion. This prevents a trustee from receiving absolute or uncontrolled discretion regardless of what the document might state or infer.

> **Note.** The amount the income beneficiary is entitled to receive from the trust is based on this computation of income. The income beneficiary is not allowed to receive any item that is not an income item. If the trust did not receive any income items during the accounting period, the income beneficiary would not receive any distributions.

On the trust income tax return, there is a deduction for taxable income distributions. The amount of this deduction is based on distributions allowed by the trust determined under applicable **state** law. Once the appropriate trust distributions have been determined, **federal** tax laws may limit the deductible amount. This interrelationship between the Code and state law applies throughout the preparation of the tax return. It is very important to follow state law, so the correct amount of trust accounting income can be determined.

Important points to remember:

- Whatever the governing document defines as income shall be allocated to income, regardless of how the item would be classified for financial accounting or tax purposes.
- If the governing document is silent, state law defines income for fiduciary accounting purposes, regardless of how the item would be classified for financial accounting or tax purposes.
- Trust accounting income determines the amount that is distributable to the income beneficiaries, not financial accounting or tax accounting income.
- Since a trust entity is a separate legal entity, how the transferor accounted for the property is immaterial.
- **Specific** provisions control over **general** provisions.
- Directly related expenses offset the specific type of income or corpus when computing net income.

OVERVIEW OF INCOME INFLOWS

Trust accounting income is primarily determined on a pure cash basis. Until the trustee receives cash or property, nothing is recorded for accounting purposes. No outflow is recorded until the trustee makes an expenditure. Beneficiary distributions are never an outflow. While the 1997 UPIA refers to receipts and expenditures, inflows and outflows will be used to emphasize the cash-based nature of trust accounting.

Only certain accounting issues will be highlighted.

Distributions from an Entity

If the trust owns an interest in a corporation (C or S), partnership, limited liability company, regulated investment company (mutual fund), real estate investment trust, or common trust fund, cash distributions are generally income items. A trustee shall allocate to corpus:

- Distributions received in a form other than money,
- Cash received in one or more distributions or a series of related distributions in exchange for part or all of a trust's interest in the entity,

- Money received in total or partial liquidation of the entity, and
- Money received from a mutual fund or REIT that is classified as a capital gain dividend for federal income tax purposes.

The trustee can rely on statements from the entity about the source and character of any distribution. Distributions from S corporations are allocated under this section, since state law does not make any distinction between S and C corporations or partnership (general and limited) interests. If the S Corporation or partnership does not make a distribution, nothing is recorded on the trust's books. Receiving a K-1 does **not** mean the trust has accounting income. Using the wrong rules can result in improper allocations.

Business and Farming Operations

Under the 1997 UPIA, the following activities may be accounted for as separate business activities, if operated as a sole proprietorship:

- Retail, manufacturing, service, and other traditional business activities
- Farming
- Raising and selling livestock and other animals
- Management of rental properties
- Extraction of minerals and other natural resources
- Timber operations

If the trustee elects to treat these activities as separate business activities, a separate set of books is maintained to account for the activity's operations. Generally accepted accounting principles (financial accounting) are used to determine the net income or loss from business operations. To the extent the trustee determines net cash receipts need to be retained by the activity for working capital, asset replacement, or other business needs, those retained receipts shall not be allocated to either income or corpus. Any cash available to be distributed can be allocated to income or corpus as the trustee deems appropriate; however, proceeds from an asset sale shall be allocated to corpus to the extent the proceeds are not needed by the activity.

If a trustee does not want to account for rental properties as a separate business activity, the net rental receipts shall be allocated to income.

If extraction of minerals and other natural resources is not accounted for as a separate business activity, rent and extension payments are allocated to income. Unless the agreement provides that productions payments are income, they are treated as corpus. Royalty, overriding or limited royalty, bonus or any proceeds from a working interest, net profit interest, and any other interest from minerals or other natural resources are allocated 90% to corpus and 10% to income. This is a major change from the 1962 UPIA which allocated the lesser of 27.5% of gross proceeds or 50% of net proceeds to corpus.

OVERVIEW OF INCOME OUTFLOWS

Certain charges against the trust must be attributed to income, reducing the amount that can be distributed to the income beneficiaries. Section 501 of the 1997 UPIA states that ordinary expenses incurred in the administration, management, or preservation of the trust property, including recurring taxes assessed against the property (e.g., property taxes), water rates, insurance premiums, interest expense, and ordinary repairs are charged against income. To the extent the trust pays income taxes on income items, the taxes are allocated against income.

Depreciation and Depletion

The most confusing expenses in trust accounting are depreciation, depletion, and amortization. The 1931 UPIA had no provision for depreciation. The 1962 UPIA made depreciation mandatory if, under generally accepted accounting principles (GAAP), the asset would be depreciated. The 1997 UPIA grants the trustee discretion as to whether depreciation is charged or not. Under all three Acts, **a residence was not depreciated.** Normally, depreciation will be charged if the trust is operating a business. Also, depreciation is charged if the trustee makes improvements that would be depreciated under GAAP. Except for these two circumstances, **whether depreciation is charged against income depends on applicable state law** or trust provisions. If depreciation is charged, the trust is said to have a reserve for depreciation. Although called a reserve, it **operates like an expense item reducing accounting income and the income beneficiaries' distributions.**

Depletion is not a separate charge, but based on the corpus allocation. A portion of depletable items is allocated to corpus. Under the 1962 UPIA, 27.5% of gross receipts is allocated to corpus, while under the 1997 UPIA, 90% is allocated to corpus. Whether the amount allocated to corpus is considered a depletion charge depends on how state law is worded. Regardless, no additional depletion amount is subtracted from income.

Trustee Fees

Both the 1962 and 1997 UPIA allocate half of trustee fees, court costs, accounting costs, attorney's fees, and costs of judicial proceedings to income and the other half to corpus.

OVERVIEW OF CORPUS INFLOWS AND OUTFLOWS

Once accounting income has been computed, whatever remains is corpus. State law normally classifies proceeds received from the sale of trust assets as corpus. This prevents a trustee from having an allocation issue each time a management decision is made. Since the proceeds, net of expenses, are allocated to corpus, any gain or loss attributed to the sale is allocated to corpus also. Repayment of a loan or other changes in an asset's form are allocated to corpus, too. Income taxes attributed to corpus inflows are allocated to corpus.

REASONABLE APPORTIONMENT AND UNITRUST

Over 40 states have enacted the 1997 UPIA. While the Act covers certain types of inflows not addressed under the 1962 Act and makes some changes in the allocation percentages, the most significant change concerns the trustee's power to adjust, otherwise known as reasonable apportionment. Once the trustee has allocated inflows and outflows according to the document and state law, the trustee can shift income to corpus or visa versa depending on the needs of the beneficiaries.

The 1997 UPIA was drafted to work in concert with the **Uniform Prudent Investor Act.** Under the Investor Act, the trustee **treats the entire trust as a single portfolio** and invests using the modern portfolio theory of investing. According to modern portfolio theory, the **entire portfolio is invested to achieve a total return,** not a particular return per investment. By investing for total return, the composition of the portfolio will be based on all the available investment options and configured to achieve a total return consistent with the trust's overall objectives.

Allocations between income and corpus create an inherent conflict between income and remainder beneficiaries. Income beneficiaries want the trustee to invest in assets that produce accounting income, while remainder beneficiaries desire an opposite investment approach. Under the traditional investment approach, the suitability of each investment was analyzed for appropriateness. This resulted in trustees mainly investing for income due to the safe nature of income investments. With the dramatic returns produced by non-income-based investments during the 1990s, many trusts missed out on these returns because the trust's assets were invested for income. By adopting a total return approach to investing, state law provided protection to trustees who altered their investment mix to realize these higher yields.

Example 4. The Hill Trust has $500,000 worth of investments. Jana, the income beneficiary, wants the trustee to invest in corporate bonds, yielding 6%, to increase her income distributions. Nancy, the remainder beneficiary, wants the trustee to invest in stock of a new technology corporation, which pays no dividends but promises a 12% annual growth rate over the next five years.

Under the traditional investment approach, the trustee would have a difficult time substantiating the stock investment due to its speculative nature. Investing only in bonds will cause erosion of the trust's assets' value, since bonds do not retain their value in respect to inflation. Nancy might challenge the trustee's investment decisions if no growth assets are purchased, while Jana might challenge the investment decisions if her income distributions decline.

The 1997 UPIA was written to assist in the allocation between income and corpus under a different investment philosophy. Since the trustee is investing to achieve a total portfolio return, the investment mix might favor growth over income. This mix might achieve a higher total return, but leave the income beneficiaries with smaller distributions because the trust's investments favor growth over income.

Once the trustee has allocated inflows and outflows under the 1997 UPIA allocation system, the trustee looks at the net income available for distribution to determine if that amount is sufficient to meet the income beneficiaries' needs. Under reasonable apportionment, if the income computed under the normal allocation system is insufficient to meet the income beneficiaries' needs, the trustee can allocate a portion of corpus to income in an amount necessary to meet the trust's obligations to the income beneficiaries.

If the trustee determines that the amounts allocated to corpus are insufficient to meet the remainder beneficiaries' needs, the trustee can allocate income to corpus. By allowing the trustee to shift income or corpus to the other beneficiaries, the trustee can invest in a manner to achieve the highest optimum return without worrying about income and corpus allocations.

In an effort to remove investments decisions from allocation disputes, some states have adopted a **unitrust approach to defining income.** Instead of allocating between income and corpus to compute available income distributions, the trust document can identify a fixed percentage of the FMV of the trust's assets, revalued annually, as accounting income. Regardless of how the assets are invested, the income beneficiaries received the same percentage of the trust's assets' value each year. The trust document should state how the distributions are composed. For example, the document should state that any income distribution is considered to come first from traditional income sources (e.g., dividends, interest) and then from corpus (e.g., capital gains — short-term then long-term).

INTERRELATIONSHIP BETWEEN ACCOUNTING AND TAXATION

While the computation of trust accounting income determines how much is distributed to the income beneficiaries, the computation of trust accounting income is also used for determining the allocation of taxable income between the beneficiaries and the trust.

IRC §643(b) states:

For purposes of this subpart and subparts B, C and D [§§641–668], the term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.

Throughout Subchapter J of Subtitle A of the Internal Revenue Code, the word "income" is used frequently; therefore, it is vital that trust accounting income for the year be computed properly. Tax depreciation and depletion are allocated between the trust and the beneficiaries based on how depreciation is handled for accounting purposes and how trust accounting income is allocated. Distributable net income is first allocated to beneficiaries who receive mandatory trust accounting distributions. These are two ways in which the tax code uses trust accounting income to allocate taxable income between the trust and its beneficiaries. While trust accounting income does not change the tax laws, it can have a bearing on who shoulders the tax burden.

The IRS has issued proposed regulations (Reg. 106513-00) that revise the definition of income under IRC §643(b) to take into account changes in how trust accounting income is computed under state law. Not only will these rules affect standard trusts, they will also affect estates, pooled income funds, charitable remainder trusts, charitable lead trusts, trusts intended to qualify for the marital deduction, and trusts exempt from the generation skipping transfer tax. The regulations will not be final until published in final form.

Provided the trust's provisions do not depart fundamentally from traditional concepts of income and corpus, under the proposed regulations, amounts allocated between income and corpus under state law will be respected. However, state law must provide for a **reasonable apportionment** between income and remainder beneficiaries of the trust's total return. The main changes under state law are to allow either an equitable adjustment or a "total return unitrust" approach to determine how much an income beneficiary should receive. The proposed regulations provide that a unitrust amount between 3% and 5% would be a reasonable apportionment of a trust's total return. An equitable adjustment between income and corpus, if made to fulfill a trustee's duty of impartiality, would meet the reasonable allocations requirement. Further, the allocation of capital gains to income will be respected if made in a reasonable and consistent manner.

Effectively, the proposed regulations allow the trust's definition of income to apply for federal income tax purposes, if it is consistent with the trust's terms and state law and the definition does not go beyond traditional allocation concepts. If a trustee's allocation is consistent with the intent of maximizing the trust's total return and maintaining balance between the income and remainder beneficiaries' interests, then the trust's definition of income will apply for tax purposes. If the trustee's allocation is primarily tax motivated, then the trust's definition of income will not apply. The IRS is attempting to adapt its regulations to conform to changing trust laws without giving trustees unbridled discretion to abuse the tax system.

If the proposed regulations are adopted in their present form, they will enhance the payment options available to planners when drafting a trust. As states adopt the 1997 UPIA and Prudent Investor Act, the battle between income and remainder beneficiaries over the trust's investments will be reduced. By allowing the IRC to change to adapt to these new options, the IRS is preventing a conflict between trust operations and tax law.

REVOCABLE INTER VIVOS TRUSTS — LIVING TRUSTS

PURPOSE FOR A LIVING TRUST

A living trust is used as an alternate way of transferring property at death instead of transferring property through probate.

OVERVIEW

Concerns about probate and incapacity have increased the use of revocable inter vivos trusts. Often they are marketed as living trusts. Many planners are recommending that their clients establish a living trust to accomplish various estate planning objectives. These trusts are created during the grantor's life and can be changed anytime before death. Only those assets transferred to the trust are controlled by its terms. Depending on the client's situation, a living trust might be a desirable planning technique.

Normally, a living trust has the following characteristics:

- It is revocable.
- The grantor is the trustee.
- A pour-over will is drafted.[4] The will follows the distribution scheme of the trust.
- On the grantor/trustee's death, the same person is named as the executor and successor trustee.

Since the grantor is named the trustee of the living trust, grantor trust rules apply. Although no income tax savings are achieved, the primary purpose of the trust is a smooth transfer of property at the grantor/trustee's death. Some authors refer to this as contingency planning.

While probate has been the traditional way for transferring property at death, the cost and timing of probate has prompted individuals to seek an alternative method of transferring property at death. The living trust is often the answer. The similarities between a living trust and a will are:

- Both can dispose of property at the client's death,
- Both name a fiduciary who is responsible for managing the client's property, and
- Both can be made amendable and revocable.

The differences between a living trust and a will are:

1. Different property is disposed of by each document:
   - The trust disposes of property owned by the trust.
   - The will disposes of the probate estate.
2. Execution requirements are different:
   - A trust has **very simple execution requirements.**
   - **A will must follow testamentary formalities.**

ADVANTAGES OF A LIVING TRUST

Reduced Probate Costs

Normally, probate costs are based on the amount of assets forming the probate estate. By transferring the bulk of his assets to the trust, the client can reduce the costs associated with transferring his property at death. Today, these cost savings are not as great as in the past. If a living trust is created, the client must still have a will; therefore, the client must pay for the drafting of two documents, not just one. Costs associated with transferring assets to the trust exist. Most states have enacted limited probate administration laws, which reduce court supervision required to probate an estate. Additionally, some states now include the trust's assets in computing the probate costs of the entire estate. From a total cost perspective, it will probably cost as much to transfer one's property through a living trust as a will; however, each state is different, so the potential costs savings can vary depending on the grantor's state.

Greater Privacy

Wills are public documents; therefore, **anyone who visits the County Clerk's office can review the probate documents.** One of the main probate documents is the "Inventory, Appraisement and List of Claims." This document is a complete listing of all assets and debts of the deceased. **A living trust is a private document.** Other than the grantor, trustee, and beneficiaries, **no one else is privy to the contents of a trust.** A trust does not make a public filing of its assets. Banks and other institutions might want to review the trust document before allowing the successor trustee on the account. For a person who wants to keep her personal finances a secret from nosey, disinterested parties, a trust is an excellent device.

> **Example 5.** Laura owns an extensive art collection. If she died and her assets were transferred through probate, each item of her collection would be listed in the inventory. By establishing a living trust and transferring her art collection to the trust, she can avoid having unintended parties know the extent of her art collection.

Speed in Transfer

Death does not stop the bills. Assets in the probate estate are subject to the claims of creditors. While the probate is in process, distributing sufficient funds to meet the beneficiaries' financial needs might be difficult. Distributions from the estate may be delayed due to various administrative factors.

A trust is not subject to such delays. Funds can be distributed from the trust because they are not subject to probate administration. However, since trusts will be subject to transfer taxes and administrative costs, some delays will also occur with a trust. The trust's assets also are subject to creditors' claims.

Reduced Litigation

Challenging the creation of a trust is much more difficult. Will contests can extend an estate for several years. The use of a living trust can reduce the chances any disgruntled beneficiary might challenge the client's wishes.

Alternative to Guardianship

When a client becomes incapable of self-management, someone must be appointed to manage the client's affairs. Failure of the client to provide for incapacity may result in the court creating a guardianship. Similar to probate, **a guardianship is carefully supervised by the court. A living trust allows the client to avoid the costs and hassles of a guardianship.** Most trusts name a successor trustee if the client relinquishes the role, becomes incapacitated, or dies. Upon the client being declared incompetent, the successor trustee would step in and take control. The client would still receive the benefits of the trust, but under different management. Since all of the assets are already in trust, costs and time are saved.

> **Example 6.** Greg, age 80, is concerned about becoming incapacitated. If this situation occurred without proper planning, someone would have to manage Greg's affairs and the court would decide who his guardian would be. Greg would have no say about the court's selection. The guardian would be required to file accountings with the court and would have to obtain court permission to undertake financial transactions.
>
> By establishing a living trust, Greg can name an alternate trustee. This person would become trustee in the event Greg could no longer perform the function of trustee. Greg would be able to choose this alternate trustee, thereby avoiding appointment of an unacceptable person and incurring unwanted court costs and time delays.

DISADVANTAGES OF A LIVING TRUST

Living trusts have some disadvantages. Living trusts do not typically save taxes. The trust will be included in the deceased's estate under IRC §§2036 and 2038. If the trust is irrevocable, the grantor might be subject to gift taxes on the remainder.

Grantor Trust Rules prevent the grantor from avoiding income taxes. Estates are taxed differently from trusts in certain areas.[5] These tax areas do not make either a will or living trust preferable to the other. One is not automatically better than the other.

Mistakenly, people believe living trusts can shelter assets from their creditors. Most state laws prevent individuals from transferring property to a revocable trust, denying attachment by the grantor's creditors. Probate offers a shorter creditor's period than most statute of limitations laws. Since property in a trust does not pass through probate, creditors are allowed to reach assets in a living trust, even after the grantor's death. A spendthrift clause can protect the assets from beneficiaries' creditors, since the beneficiaries did not create the trust.

> **Example 7.** Norton was in the real estate business. He had several outstanding loans when he died. If his assets are transferred through probate, the creditors would have approximately six months after Norton's death to file a claim against the estate for payment of their obligations.
>
> If Norton had established a living trust, his creditors would have two or more years to sue the trust for payment of their claims. While neither Norton's heirs nor trust beneficiaries would be liable for Norton's debts, Norton's creditors can still file suit to obtain payment, reducing potential inheritance.

While a living trust does not save federal estate tax directly, by having the property allocated to different trusts at the deceased's death, the living trust can incorporate many estate tax trusts discussed later. Any trust that can be used in a will can be included in a living trust. Living trusts are best for clients who own property in several states. Avoiding ancillary probate in every state where the deceased owned property can significantly reduce transfer costs.

ESTATE TRUSTS

Saving estate taxes with various trusts has been part of the estate planner's arsenal for many years. Estate trusts allow the planner to fully exploit the tax reduction opportunities provided through leveraging the applicable credit and marital deduction. A marital estate of $2,000,000 can be completely sheltered from transfer tax. The key consideration is determining exactly how much property must be passed to the surviving spouse (S_2). If too much or too little property is passed to S_2, excessive estate taxes will be paid.

Before examining the main types of estate tax trusts, a review of primary estate transfer objectives is helpful:

- IRC §2056 allows for an unlimited marital deduction (MD) for property transferred to a U.S. citizen's spouse.[6]
- No deduction is allowed if the property transferred to S_2 is subject to any form of a contingency. A contingency would cause the transfer to violate the terminable interest rule.
- No MD is allowed if the transfer is subject to a terminable interest. A terminable interest is defined in §2056 as "an interest which will terminate or fail. . . on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur."
- Many clients like the idea of not paying any taxes at the first spouse's death, so they draft wills or living trusts which transfer all of their property to the other spouse taking advantage of the MD. This is called the 100% marital deduction option. Except for small marital estates, the **100% marital deduction will always result in excess estate taxes being paid.**

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Each person is entitled to an applicable credit. In 2003, the credit equals $345,800. Since the credit cannot be transferred to or used by another person, a person must have a taxable estate or tentative tax base before the credit can be used. Without a taxable estate, the credit will be wasted. Wasting the credit means $345,800 in taxes will be paid needlessly. The primary goal of the estate tax trusts is to balance the property retained by the first spouse and the property transferred to S_2, so maximum use of both spouses' applicable credit can be achieved.

MARITAL DEDUCTION TRUSTS

Purpose for a General Power of Appointment (GPOA) Trust:

A GPOA trust is used if the deceased spouse wants property passing to the surviving spouse to qualify for the marital deduction, but desires the controls/management afforded by a trust. While the surviving spouse will have the ability to alter the ultimate distribution scheme provided for in the trust, this post mortem control enables the surviving spouse to change any potential distribution as circumstances warrant.

Overview

At death, the first spouse (S_1) has the option of transferring property outright to S_2 or transferring the property to a trust for S_2's benefit. Reasons for transferring the property into trust include the following:

- Health and/or age of S_2
- Financial management skills of S_2
- The first spouse's desired distribution scheme

Whether to use a trust or not involves these and other nontax reasons. If a trust is used, qualifying or not qualifying the transfer for the marital deduction becomes a consideration. Without any other provisions, transferring property to a trust for the benefit of S_2 does not qualify for the marital deduction (MD). Since S_2's interest in the trust ends at S_2's death, the terminable interest rule under IRC §2056 disallows any MD for property transferred to the trust. An exception to the terminable interest rule is a **marital deduction trust.** This trust is also known as an "A" trust or **GPOA trust.**

A **marital deduction trust** gives S_2 a general power of appointment over the trust property. A general power of appointment is defined in IRC §2041 as a power where the holder can transfer property to the:

- Holder,
- Holder's creditors,
- Holder's estate, or
- Creditors of the holder's estate.

IRC §2041 states that a holder of a GPOA is considered the owner of the property subject to the power for estate tax purposes. As the owner, the holder must include any assets subject to the GPOA in the holder's gross estate. A GPOA results in property not originally owned by the holder being included in the holder's gross estate, even if the holder never received any benefits from the property. A GPOA can be converted to a limited power of appointment if the power is subject to an ascertainable standard.

IRC §2056(b)(5) allows an MD for property passing to S_2 in trust if S_2 is the holder of a GPOA over the trust. Further, the section requires that the trust's accounting income must be payable to S_2 at least annually and the GPOA must be exercisable by S_2 only. S_2 must have the right to exercise the GPOA during life or at death, and no other person can have the right to income or to appoint the property in the trust while S_2 is alive. **If the requirements of the marital trust are met, all property transferred to the trust is eligible for the marital deduction.**

Why Use a Marital Deduction Trust?

1. The first spouse might want some **control over who receives the property at S_2's death.** If the property is given outright to S_2, S_2's estate plan will make the final distribution of S_1's property. By placing the property in trust, the trust document determines who receives the remainder at S_2's death. This allows the first spouse to name the trust's remainder beneficiaries and gives S_1 some control over the disposition of S_1's estate. However, S_1 does not have complete control, since S_2 has a GPOA. If S_2 wanted to give the property to someone else, S_2 can. The first spouse could limit the GPOA to death transfers only, but S_2 still has some control over the first spouse's property.

2. The first spouse might **want S_2 to have some say on who receives the property at S_2's death.** The surviving spouse might be in a better position to know who would be best to receive the property. Events might have changed, that if known by S_1 would have resulted in a different disposition than provided for in the trust. Since S_2 has a GPOA, S_2 can distribute the property to different people than covered by the trust, allowing for greater flexibility in S_1's estate plan. This result is magnified if S_2 can exercise the GPOA during life and at death.

3. The first spouse **wants to provide for S_2 during S_2's lifetime while retaining the MD.** Although the first spouse wants the property ultimately to go to other beneficiaries, S_1 wants to care for S_2 during her life. However, IRC §2056 prevents a marital deduction subject to a terminable interest. An MD trust allows S_1 to provide for S_2 while still having the transfer eligible for the MD.

4. If S_1's estate is primarily composed of a closely held business, a **GPOA trust enables S_2 to make gifts of the interest, reducing the percentage ownership of the business to be included in S_2's gross estate.** Being able to reduce S_2's ownership below 50% might allow S_2's executor to take advantage of various discounts.

5. **S_2 can be the trustee of the MD trust**.

Example 8. Andy owns a successful business, which operates as a C corporation. To avoid paying estate taxes were he to die first, he must gift some stock to his wife, Char, so it qualifies for the MD. Andy wants the stock to go to his three children after Char dies. Jason, one of Andy's children, has joined a religious cult of which Andy does not approve. Although Andy wants the stock to go to all of his children, he does not want the stock to go to Jason if he is still a member of the cult.

If the stock's value continues to grow after Andy's death, the stock owned by Char might cause her to owe estate taxes when she dies. By transferring the stock to an MD trust, Andy can avoid paying estate taxes when he dies. If Char does not exercise her GPOA, the stock will go to his three children at Char's death.

Char can make gifts of stock during her life to reduce her gross estate. Also, she can make gifts of stock to avoid having any of the stock go to the child who is a member of the cult.

If an MD trust is selected, nonappreciating assets should be used to fund the trust. Since the trust assets will be included in S_2's gross estate, valued at FMV date of S_2's death, having assets that do not appreciate will reduce the federal estate tax at S_2's death.

BYPASS TRUST

Purpose of a Bypass Trust

A bypass trust causes property from S_1 to be subject to tax when S_1 dies, but not S_2, allowing use of S_1's applicable credit without disinheriting S_2.

Overview

Every person has an applicable tax credit unique to that person. It cannot be transferred and used by another person. If not used, the credit is lost forever. Before the applicable credit can be used, a taxable estate must exist. Having a taxable estate means that some property transferred which did not qualify for the marital or charitable deduction. Not having transferred property qualify for the MD occurs when either the property is transferred to someone other than S_2 or the transfer to S_2 does not qualify for the MD. Most spouses want to provide for the surviving spouse's needs after their death; therefore, they do not want to transfer the property outright to someone other than S_2. A bypass trust[7] is used to provide for S_2 while taking full advantage of the deceased's applicable credit.

S_2's interest can be limited as much as desired. If the goal is to provide the maximum benefit for S_2, the bypass trust can be structured two ways:

1. Life estate to S_2
2. Life estate to S_2, with S_2 having a power of appointment (POA) subject to an ascertainable standard and/or a five and five power (defined later)

If S_1 believes the trust's accounting income will be sufficient to provide for S_2, then S_2 does not need the ability to invade the corpus. Concern for S_2 and a desire to increase post mortem flexibility limits the use of this option, so most bypass trusts give S_2 limited power to receive some corpus based on future events. If the power to invade is too great, S_2 will be deemed to own a GPOA that results in the trust property qualifying for the MD. Limiting the invasion power by an ascertainable standard or to a five and five power will cause S_2's interest not to qualify for the MD and allow the trust property to be included in the deceased's taxable estate.

An ascertainable standard relates to the health, education, support, or maintenance of S_2. Use of the POA is reasonably measurable based on S_2's health, education, support, or any combination of them. Since S_2's power is limited, the POA is not treated as a GPOA for estate tax, preventing it from being included in S_2's gross estate under IRC §2041. An ascertainable standard gives S_2 the right to use the trust's corpus in case of emergencies or lack of other funds. The first spouse can rest assured, knowing S_2's standard of living will be sustained. The surviving spouse does not have unbridled use of the trust's corpus. The inability to use the corpus for any purpose causes the transfer not to qualify for the MD, which is the goal of a bypass trust.

Note. The phrase "health, education, support, or maintenance" is a term of art. The IRS has litigated powers that did not use the exact words found in the IRC §2041 Regulations and courts have upheld the IRS, which results in inclusion of the trust's corpus in S_2's gross estate.[8] Care must be taken to assure that the POA is limited by an ascertainable standard.

A "five and five" power refers to the holder's limited ability to remove the greater of $5,000 or 5% of the trust corpus. Under the provisions of IRC §§2041 and 2514, the holder of a five and five power can withdraw annually the greater of $5,000 or 5% of the property subject to the power without having the power considered as a GPOA. Each year the right to withdraw the funds lapses, and since the power is noncumulative and not a GPOA, the holder is not deemed to have made a gift. By giving S_2 the right to withdraw this amount annually, S_2 has made no gift and the trust corpus will not be included in S_2's gross estate. S_2's gross estate will include the value of the lapsed, unexercised right in the year of death, since the right is a property interest owned by S_2 at death. S_2 must include the property subject to the five and five power even if power is subject to a contingency. A five and five power gives S_2 additional funds, if needed, without losing the benefits of a bypass trust.

The greatest benefit of a bypass trust is sheltering of future appreciation. Hopefully, the deceased's assets will continue to appreciate after death. If these assets were added to S_2's assets, S_2's estate would be subject to higher estate tax brackets. By bypassing S_2's estate, these assets pass to future generations without having them subject to an additional federal estate tax at S_2's death, while still allowing S_2 to benefit from the assets during life.

Example 9. Harry transferred $675,000 to a bypass trust. His wife, Barbara, enjoyed the income from the trust during her life. At her death, the trust ended and $1,500,000 passed to the children. If the $1,500,000 had been included in Barbara's gross estate, at least $210,000 in federal estate tax would have been owed, leaving the children $1,290,000 instead of $1,500,000. Use of the bypass trust leveraged the applicable credit, allowing both Barbara and the children to receive more property than without the trust.

QUALIFIED TERMINABLE INTEREST PROPERTY (QTIP) TRUST

Purpose of a QTIP Trust

A QTIP trust allows S_1 to control the ultimate distribution of property once S_2 dies, without losing the marital deduction.

Overview

A marital deduction is allowed for QTIP, which is property:

- That passes from the deceased,
- In which the surviving spouse has a qualifying income interest for life, and
- For which an election by the executor is made to treat the property as QTIP.[9]

QTIP is treated as passing to S_2, and no part of the property is treated as passing to anyone other than S_2. If the election is made, the property subject to the election is included in S_2's gross estate under IRC §2044.

S_2 has a **qualifying income interest** for life if:

- The spouse is entitled to all income from the property, payable annually or at more frequent intervals and
- No person has the power to appoint any part of the property to a person other than the spouse during S_2's life.

The following have been ruled to **disallow the QTIP election:**

1. Any limitation or contingency on S_2's right to all income.
2. The trustee can pay any money to anyone other than S_2, even with S_2's consent.

3. The trustee can accumulate income beyond the annual distribution requirement.
4. Right to stop income distributions if S_2 becomes incapacitated.
5. S_2 has a limited POA, which allows distributions to someone other than S_2.
6. Trustee's ability to sell assets for less than FMV to someone other than S_2.

S_2 can have the following powers **without prohibiting the QTIP election:**

- A GPOA over the trust corpus, where S_2 is the only permissible appointee
- A limited testamentary POA

The IRS applies the income interest requirements literally. If the terms of the trust potentially allow anyone other than S_2 to benefit from the trust during S_2's life, no QTIP election is allowed.

Use of a **QTIP trust,** also known as a C trust, **gives the deceased more control and greater flexibility than a marital deduction trust.** In our society, second and third marriages are common. Blended families seem to have become the norm. Since the deceased might have children from a first marriage, the QTIP trust offers the deceased safeguards not available through a marital deduction trust.

1. **A QTIP trust allows the deceased to care for S_2 for life.** The requirements of the income interest ensure that S_2 will be the only person receiving property from the trust during S_2's life.
2. **The surviving spouse cannot be allowed to give any of the income interest away during life without negative federal gift tax consequences.** IRC §2519 states that any disposition of any portion of the income interest will result in S_2 making a gift of the entire nonincome interest portion. Rev. Rul. 98-8 held that the purchase of the remainder interest by S_2 resulted in a gift of the remainder interest, since the property was already included in her estate and the only item being transferred was the value of the promissory note being used to purchase the remainder interest. Because S_2 did not receive anything of value in exchange for the note, S_2 was deemed to have made a gift of the note. The reverse is not true. In Ltr. Rul. 199908033, corpus beneficiaries were deemed to have made a taxable gift when they transferred their remainder interest to the surviving spouse. While a remainder interest may have zero value when sold by the spouse, it has value when gifted to the spouse.
3. **No one other than S_2 can receive any portion of the corpus during S_2's life.**

If the deceased is concerned about his children receiving the trust corpus after S_2's death, a QTIP trust solves this problem. By not giving S_2 any POA over the trust corpus, the deceased determines who will receive the corpus at S_2's death; therefore, the ultimate disposition of the property is controlled by the deceased. With a marital deduction trust, the deceased must hope S_2 does not exercise the GPOA for a different beneficiary.

Further, the executor has the ability of determining the correct amount of MD. With a marital deduction trust, the property automatically passes to the trust and qualifies for the MD. What if a need exists to increase the non-MD property? Only through a QTIP is an executor allowed to balance the allocation between MD and non-MD property without altering the deceased's disposition scheme through the use of a partial QTIP election.

The QTIP trust is very popular. Clients enjoy the dispositive control offered through a QTIP trust. While being concerned about the well-being of S_2, clients do not want their property going to an unplanned beneficiary. Though the FMV of the property at S_2's death will be included in S_2's gross estate, clients are more concerned with the right people enjoying the property than possible increased estate tax.

GIFT TRUSTS

Property retained until death will be subject to estate taxes. Although the estate tax is scheduled to be repealed in 2010, under current law, it is scheduled to return in 2011. Consequently, transferring property during life is a means to avoid potential estate taxes later.

Gifted property is subject to tax based upon its value at the time of the transfer. By transferring property during life, not only will a lower amount be subject to tax, but all future appreciation will be removed from the gross estate.

Gifts can be made outright or in trust. Outright gifts result in the donor losing control over the gifted property. Through a trust, a donor can retain some control over the property while achieving additional gift tax savings. Regardless of how the gift is made, the donor will relinquish ownership of the property, so care must be taken to assure that the donor is financially able to make a gift and is mentally ready to lose use of the property.

IRREVOCABLE LIFE INSURANCE TRUST (ILIT)

Purpose of a Life Insurance Trust

An ILIT enables cash to be available for the payment of debts, taxes, and other liquidity needs once the decedent dies without having the insurance proceeds included in the decedent's gross estate.

Overview

Liquidity is a major concern for most estates. If a large federal estate tax liability is expected, the client must plan to have sufficient cash to pay the estate tax. Life insurance provides the means by which the client can have the instant cash reserves necessary to pay federal estate tax and other transfer costs. Life insurance proceeds will be included in the client's gross estate if the client is the insured. This is true whether the proceeds are received by the client's probate estate or the client possessed any incidents of ownership in the policy. The size or value of the client's ownership interest in the policy is irrelevant. Any form of ownership causes the entire proceeds to be part of the client's gross estate.

An ILIT can accomplish the following goals:

1. **Exclude the insurance proceeds from income taxation and from estate taxation** of both spouses and perhaps the children.
2. **Exclude the insurance proceeds from the probate estates** of both spouses.
3. **Enjoy the shelter of the gift tax annual exclusion for transfers to the trust** of both the policy and the funds needed to pay policy premiums.
4. Ensure that a reasonable party will in fact **provide the needed post death liquidity.**
5. **Make the proceeds available to the surviving spouse,** for health or other reasons.

Careful drafting is required for an ILIT to function properly. Accomplishing each goal requires combining the various estate, gift, and income tax rules, so the proceeds are sheltered from tax.

The operation of a properly structured ILIT includes:

1. **The grantor establishes an irrevocable trust and names a third party to be the trustee.** IRC §2036(a) prevents the grantor from naming himself as trustee. If S_2 is going to be a beneficiary, the spouse should not be named as trustee. The combination of control, as trustee, the Crummey power,[10] and beneficial ownership could cause the trust corpus to be included in S_2's estate at her death.[11]

   Further, if S_2 is deemed an owner of the policy and the proceeds are paid to someone else, the spouse will be treated as making a gift of the proceeds to a third party, subject to gift taxation. Being named as a beneficiary does not make the person an owner of the policy. However, when combined with the trustee's powers, ownership may be attributed to the spouse causing negative transfer tax consequences when the proceeds are paid at his death.

2. **The grantor will have no interest in the trust and will lose all control over the assets placed into trust and any income generated from those assets.** The purpose of the ILIT is to provide sufficient liquidity once the grantor dies. This can be achieved only by removing the proceeds from the grantor's gross estate. If the grantor has any right to income or retains the right to control the trust in any manner, the IRS will hold that the grantor has incidents of ownership over the policies.

   The assets used to fund the trust will determine if the spouse should have any right to income. If the spouse owned any of the assets used to fund the trust, giving the spouse a beneficial interest in the trust could cause some of the trust to be included in S_2's gross estate. The surviving spouse will be found to have transferred property and retained any interest in that property subjecting it to inclusion under IRC §2036(a). This is especially true in community property states. If the couple's estate plan calls for a federal estate tax liability at S_2's death only, S_2 does not have to have any beneficial interest in the trust, preventing the need to work around the ownership issues. Funding the trust with a second-to-die policy results in no distributable assets until both spouses are dead.

3. **The trust is given the power to purchase insurance on the life of the grantor, spouse, and any other person for which the grantor has an insurable interest.** At death, the trustee will have the right, but will not be required, to lend or purchase assets from the grantor's estate. This right gives the trustee the power to transfer cash from the trust in exchange for assets of the estate. Since the trust is not obligated to deal with the estate, none of the policy proceeds transferred to the estate will be deemed paid to the estate. If the trust is required to buy or lend the estate money, the IRS has ruled that any funds transferred will be considered payments of policy proceeds to the estate and included in the grantor's gross estate.[12]

4. **Management of and distributions from the trust are determined by the grantor.** While the grantor does not make the management decisions, specific restrictions and allowances can be stated in the trust document. No special distribution rules exist, except toward the grantor and possibly the spouse. The grantor can use the trust to accomplish any estate planning objective. Since the assets will be free from transfer taxes, more assets will be available to use to achieve the grantor's objectives.

5. **With cash from the grantor, the trust will purchase the insurance policies.** While the grantor can transfer existing policies to the trust, a better approach would be for the trust to buy new policies. IRC §2035 requires the proceeds of all insurance policies on the life of the grantor to be included in the grantor's gross estate if transferred within three years. This is not true with new policies. New policies allow the proceeds to be immediately excluded from the grantor's gross estate, while the grantor must live three years before existing policies are excluded.[13]

6. **Two types of ILIT exist — funded and unfunded.** A funded trust has income-producing property, while an unfunded trust does not. If the grantor provides the income-producing property and the income is or can be used to pay the premiums, the grantor will be taxed on the income.[14] Unfunded trusts normally own the policies only. Annually, the grantor makes additional corpus contributions to make the premium payments. Since the additions are not taxable trust income, no tax effect exists. Income-producing property contributed by a third party used to pay premiums will not cause the grantor to be taxed on the income.[15] **If the grantor contributes income-producing property to a trust, the grantor will be taxed** despite:

   a. The premium payments are made according to the trust document,

   b. The policies are owned originally by the grantor or purchased later by the trust,

   c. The trust is irrevocable, or

   d. The type of insurance policy.

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7. Several challenges are present when attempting to shelter trust contributions from federal gift tax. Since the beneficiaries do not receive a present interest in the insurance, none of the contributions qualify for the annual exclusion.[16] Use of a withdrawal power allows the grantor to use the annual exclusion to exclude the contributions from gift tax. However, the beneficiaries will be deemed to have made taxable gifts if the value of the withdrawal power exceeds the five and five power. In addition, possession of a Crummey or five and five power will cause the person to be subject to income taxes as the trust's owner over that portion of the trust.[17] As discussed earlier, **limiting the withdrawal right to the five and five power will avoid any gift tax by the beneficiary. Using an unfunded trust should allow the beneficiary to escape any income taxes.**

While life insurance can be owned outright by third parties, greater flexibility is available if owned by a trust. The ability to transfer the proceeds to a future generation free of transfer taxes is increased through use of a trust. ILIT is a popular estate planning tool. Life insurance provides a quick source of needed cash, which saves the estate the unnecessary costs of too little liquidity.

INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

Purpose of an Intentionally Defective Grantor Trust (IDGT)

An IDGT allows the grantor to remove appreciating property while freezing the estate's value for estate taxes. By selling the property to the IDGT, the grantor can transfer the property's appreciation while limiting potential gift taxes.

Overview

Income tax brackets for trusts have been greatly compressed. For example, for tax years beginning in 2003, the 15% rate only applies to a trust's taxable income up to $1,900 and the top rate of 35% applies at taxable income over $9,350.

If the grantor trust rules apply, the grantor is the deemed owner of the trust property and is taxed on the taxable income of the trust. If the entire trust is covered by the grantor trust rules, all taxable income, including capital gains, is taxed to the grantor. Based on current trust tax rates, having income taxed to the grantor can save income taxes. However, a goal of establishing lifetime trusts is to exclude the trust's assets from inclusion in the grantor's gross estate. The term **"intentionally defective grantor trust"** applies to a trust where the **income is taxed to the grantor but the assets are excluded from the grantor's gross estate.**

Example 10. Lucy Smith establishes a **non grantor trust** for her oldest son, Al, on January 1, 2003. The trust will have $20,000 of taxable income for 2003. None of the income is distributed to Al, so it is taxable to the trust. The trust's tax for 2003 is **$6,146**.

Assume instead that the trust is a **grantor trust** and Lucy is taxed on the $20,000 of trust income at a rate of 25%. (For simplicity, ignore the effect of the income from the trust on Lucy's itemized deductions and other tax benefits affected by higher levels of AGI.) The tax to Lucy would be **$5,000,** producing an income tax saving of **$1,146.**

Not only do **defective grantor trusts save income taxes,** they have an additional benefit. The grantor's payment of the income tax on the trust income under the grantor trust rules is **not regarded as a gift to the beneficiary** since the grantor is under a legal obligation to pay the tax. This means that **more assets will be in the trust when the beneficiary needs the funds** than if taxes were paid out of the trust. The grantor must come up with the cash each year to pay the tax. However, the grantor benefits by being able to make a gift tax free transfer to the beneficiary.

This strategy poses the danger of having trust assets included in the grantor's estate under one or more of the estate tax rules. Under these rules, retained powers or strings over trust property cause its inclusion in the grantor's estate. Discrepancies between the grantor trust rules and the estate tax rules make it possible to have the income taxed to the grantor without the property being included in his estate. For example, carefully limiting a grantor's administrative control over a trust, making the grantor's spouse a discretionary beneficiary, or giving the grantor the power to substitute property of an equivalent value, are techniques to achieve the desired results. The key is to avoid estate tax while having the income taxed to the grantor.

The Tax Court in *Estate of Jordahl,* 65 TC 92 (1975), ruled that an IRC §675(4) power was not a power to alter, amend or revoke the trust under IRC §2038(a); therefore, use of an IRC §675(4) "Power of Substitution" will result in the grantor trust rules applying to the income, while achieving the desired estate tax results. Under the grantor trust rules, part or all of the trust may be subject to the rules. If only part of the trust is covered, the rest of the trust is taxed as a regular trust under IRC §§641–668. **The preferred income tax objective is to have all of the taxable income included on the grantor's return to avoid the trust's compressed income tax brackets.** By combining several grantor trust rules, the entire trust will be covered.

To obtain the desired benefits, the **grantor cannot be a beneficiary of the trust.** Further, it is best if the **grantor not serve as trustee.** While several limited powers could be retained by the grantor while serving as trustee, too many or too broad a range of powers could create an inference of the grantor having retained power causing inclusion in her gross estate. Also, naming the spouse as trustee should be avoided unless the spouse is prevented from placing assets in the trust. The spouse should be prohibited from distributing trust assets to himself, except as limited by an ascertainable standard, and the trust should prohibit the spouse from making any distribution, as trustee, that would satisfy any legal obligation of the spouse.

Allowing the grantor to replace trust assets with other assets affords various planning opportunities. Since the trust's assets will not be included in the grantor's gross estate, post-transfer appreciation is removed from the gross estate. Combined with the income tax savings, defective grantor trusts offer significant total tax reductions.

GRANTOR RETAINED TRUSTS

Purpose of a Grantor Retained Trust (GRAT, GRUT, and QPRT)

Whether a GRAT, GRUT, or QPRT is established, all three trusts have the purpose of transferring the property's future appreciation at a small gift value.

IRC §2702 — General Provisions

When a donor transfers property to another and retains an interest in the property, the gift amount is computed by subtracting the present value of the retained interest from the FMV of the property transferred. The remaining amount is the value of the gift. The transferor's retained interest is valued using IRC §7520 rules. If IRC §2702 applies, this formula may be altered depending on the terms of the transfer. Unless an exception is met, the retained interest is valued at zero. For gift tax purposes, the transferor is deemed to have made a taxable gift of the FMV of the property, since the gifted interest is not eligible for the annual exclusion.

IRC §2702 applies to transfers in trust between family members. The existence of a trust is not required for IRC §2702 to apply. Any transfer in which one or more term interests exist is considered a transfer in trust. A term interest means a life interest or an interest for a term of years. A joint purchase of property by members of a family is treated as a purchase of the property by the holder of the term interest, followed by a transfer to the remainder interest owners. While IRC §2702 has four exceptions, only two are applicable for purposes of this chapter:

1. A transfer of the interests in a personal residence, where the transferor will continue to use the property as his personal residence throughout the term interest, is not subject to the rules. (Qualified Personal Residence Trust)
2. A transfer in which the transferor retains a qualified interest is valued under IRC §7520 rules and not IRC §2702.

Before IRC §2702 applies, property must be transferred to a **member of the family** and the transferor or **applicable family member** must retain an interest in the transferred property.

Member of the family includes:

- The individual's spouse,
- A lineal descendant or ancestor of the individual or the individual's spouse,
- Any brother or sister of the individual, and
- The spouse of any such descendant, ancestor, brother, or sister.

Applicable family member includes:

- the individual's spouse,
- an ancestor of the individual or the individual's spouse, and
- the spouse of any such ancestor.

Grantor Retained Annuity Trust (GRAT)

A GRAT is a trust that pays a qualified annuity to the grantor for a specified term. At the end of the term, the beneficial interest shifts to another beneficiary. A qualified annuity must be a fixed amount, which means either:

- A stated dollar amount or
- A fixed percentage of the initial FMV of the property.

The amount must be paid at least annually and the current year's payment can be no more than 120% of the preceding year's payment. The following is an example of qualified annuity payments.

Example 11. Chris transfers $1,000,000 to a 4-year GRAT. He is entitled to $100,000 in the first year, $90,000 in the second year, $50,000 in the third year, and $60,000 in the fourth year. After the fourth payment, the GRAT ends.

Example 12. Peggy transfers 100 shares of ABC Corporation to a 4-year GRAT. She is entitled to 10% of the initial value in the first year, 12% in the second year, 14% in the third year, and 16% in the fourth year. After the fourth payment, the GRAT ends.

Note. Because the trust is irrevocable, and the grantor retains no right to alter the terms of the trust, the transfer of funds to the trust is a completed gift of the value of the property transferred less the value of the grantor's retained rights in the trust. The greater the value of these retained rights for gift tax purposes, the lower the value of the taxable gift.

Example 13. On July 15, 2000, Carson puts $1,000,000 into an irrevocable trust in which he retained the right to receive $100,000 per year for 10 years – a GRAT. At the end of 10 years, the balance in the trust is to be distributed outright to his daughter, Olivia. If Carson dies before the end of the 10-year period, the remaining annual payments go to his estate.

The remainder interest that Carson transferred to Olivia is valued for gift tax purposes by subtracting the present value of the annuity payments from the $1,000,000 value of the trust on the day it was created. The present value of the annuity payments is computed by multiplying the $100,000 annual payments by 6.71. This is the annuity actuarial factor for the IRC §7520 interest rate for July 2000 (8%) and a 10-year term certain. It can be found in Table B of IRS Pub. 1457, or can be derived from the remainder factor for a 10-year term certain from Table B of Treas. Reg. §20.2031-7(d)(6). The value of the remainder interest transferred to Olivia is $329,000, computed as follows.

Value of trust on July 15, 2000		$1,000,000
Less value of retained annuity		
Annual payments	$100,000	
Annual actuarial factor	× 6.71	
		(671,000)
Value of remainder interest		**$ 329,000**

Example 14. On August 15, 2003, Sam transferred $1,000,000 into an irrevocable trust which is to pay him an annual annuity of $100,000 for 10 years. At the end of the 10 years, the balance in the trust is to be distributed to his son, Bill.

The annuity actuarial factor for IRC §7520 interest rate for August 2003 (3.2%) is 8.44. The value of the remainder interest transferred to Bill is $156,000 computed as follows.

Value of trust on August 15, 2003		$1,000,000
Less value of retained annuity		
Annual payments	$100,000	
Annuity actuarial factor	× 8.44	
		(844,000)
Value of remainder interest		**$ 156,000**

Note. The interest rate environment has a direct effect on the taxable amount of the gift.

Assuming a constant growth rate over the entire term, increasing the annuity payments will produce more value for the beneficiaries at the trust's end than will a constant annuity payment. This result is due to the ability of the trust to retain assets in the early years, allowing them to compound. While payments greater than the stated annuity are allowed, the value of these payments is zero. When the percentage method is used, an adjustment of the payment must be required by the document if the initial valuation is incorrect. **Additional amounts may not be contributed to a GRAT.**

Short term GRATs that are 2–3 years are recommended more than longer term GRATs.[18] The shorter term offers two advantages:

1. Reduces the possibility of poor investment performance
2. Reduces the possibility the grantor will die before the term ends

Creating a successful GRAT is based on several assumptions. The main factor is the ability of the trust assets to produce a total return greater than the IRC §7520 rate for the full term. This will allow substantially more property to be passed to the beneficiaries. If the total return is equal to or less than the IRC §7520 rate, more assets will be returned to the grantor. While the trustee will invest in investment quality instruments, the final return is determined by many events beyond the trustee's control. Poor investment performance in one or more years could dilute or eliminate the yields in other years, eradicating the benefits of the GRAT. Establishing several short term GRATs would allow the grantor to transfer some of the property over a longer period, while still receiving the benefits of a short term GRAT. Using the staggered GRAT approach allows the grantor to retain control over the property for the desired period, but avoid the problems associated with putting all of the funds in a single GRAT for a long term.

Observation. A GRAT is often used to leverage or multiply the amount of assets that can be gifted. By transferring rapidly appreciating assets into the GRAT, the value left for the beneficiaries at the end of the trust period can be substantially more than the value of the asset at the time of transfer. This increase in value escapes any gift tax.

Grantor Retained Unitrust (GRUT)

A GRUT is a trust which pays a fixed percentage of the net FMV of the trust assets, determined annually. The amount must be paid at least annually and the current year's payment cannot be more than 120% of the preceding year's payment. **Additional amounts can be contributed to a GRUT,** unlike a GRAT. **An income-only or an income-with-make-up provision is not allowed with a GRUT.** The ability to shift extra wealth is not as effective with a GRUT; therefore, other entities are used more often.

A GRAT is chosen more frequently, due to three advantages:

1. A GRAT does not need future revaluations.
2. The property's value is frozen when it is transferred to a GRAT.
3. Like a charitable lead trust, the value of the retained interest can be made to approximate the value of the transferred property, reducing the remainder's value and potential gift tax.

Qualified Personal Residence Trust (QPRT)

IRC §2702(a)(3)(A)(ii) excludes certain trusts, whose sole asset is a personal residence, from IRC §2702 coverage. Since these trusts are exempt, IRC §7520 can be used to value the retained interest. Two types of trusts are exempted under this provision:

1. Personal residence trust
2. Qualified personal residence trust

Each individual may have only two such trusts. If an original personal residence trust is converted to a qualified interest trust, it is no longer considered a QPRT and a new trust can be formed. Furthermore, separate trusts holding fractional interests in the same residence are considered one trust. A married couple could each have three residences in trust: two for separately owned homes and another holding a fractional interest in a jointly owned home.

A **personal residence trust** is a trust that prohibits the holding of any asset other than the personal residence. At the end of the term period or at death the property passes to the beneficiaries. Due to its inflexibility, a personal residence trust will not be discussed.

For IRC §2702 not to apply, a QPRT must meet certain qualifications. These requirements must be included in the trust document and continue throughout the term or the trust will be disqualified.[19] Final Regulations require the trust document to prohibit sale of the residence back to the grantor, the grantor's spouse, or an entity controlled by the grantor or grantor's spouse. A trust will not be deemed to have made a prohibited sale if the trust provides for a reversionary interest or testamentary power of disposition in the event the grantor dies prior to the trust's expiration. The trust may provide for the disposition, at the end of the trust, to the grantor, the grantor's spouse, or a grantor trust. The grantor can still rent the residence after the trust's term ends, providing the residence is rented for fair rental value.

No distributions can be made to anyone, other than the grantor, during the trust's term. All income must be distributed at least annually. Except for some cash, the trust is allowed to hold only one residence that must be used as a personal residence by the term holder. Improvements to the residence may be added to the trust, providing the residence continues to be used as a personal residence. If the residence is damaged or destroyed and becomes unusable, the trust ceases to be a QPRT two years after the date of damage, unless the term ends earlier or the residence is repaired or replaced. No commutation is allowed. Any cessation of use as a personal residence ends the trust. If the trust or any of the trust assets cease to be a QPRT, those assets must be distributed to the term holder or meet the requirements of a GRAT for the remainder of the term within 30 days.

Unlike a personal residence trust, a QPRT may hold certain amounts of cash in a separate account. The trustee must determine and then distribute any excess cash to the term holder. This calculation must be made at least quarterly. If the trustee sells the residence, all sales proceeds must be used to purchase a replacement residence no later than the earliest of:

- Two years from the date of sale,
- The end of the term holder's interest, or
- The date the replacement residence is purchased.

Failure to repurchase or use all of the proceeds to purchase the replacement residence within the required time causes those assets not used to cease being qualified as a QPRT. A QPRT may own insurance policies on the residence. If insurance proceeds are received due to the damage, destruction, or involuntary conversion of the residence, all of the insurance proceeds must be used to purchase a replacement residence under the same rules that apply to a sale.

Example 15. Karen, age 60, transfers her personal residence, worth $400,000, to a QPRT. The trust's term is 15 years, after which the trust will terminate and the residence will be distributed to Karen's daughter, Kathy. Karen retains a reversionary interest, whereby the house will revert to her estate if she dies during the trust's term.

At the time of the transfer, the IRC §7520 rate is 7.4%. The value of the remainder interest would be $96,879. At a 49% gift tax rate, the QPRT saves $148,529 in gift tax (($400,000 – $96,879) × .49). Any appreciation would be removed from Karen's estate thereby saving estate tax. The tax savings are based on the existence of an estate tax when Karen dies.

CHARITABLE TRUSTS

CHARITABLE REMAINDER TRUSTS (CRT)

Purpose of a Charitable Remainder Trust

A CRT allows the grantor to obtain an income, gift, and/or estate tax deduction for the present value of the charity's future interest. The tax-exempt nature of the trust allows investment returns to accumulate tax deferred until distributed to the income beneficiary. The various forms of CRUT enable the trust to be structured to accommodate the form of asset contributed to the trust.

Overview

IRC §664 specifies **two types of charitable remainder trusts,** for which a charitable income, gift, and estate tax deduction are allowed. The two types of charitable remainder trusts are a:

- Charitable remainder **annuity trust** and
- Charitable remainder **unitrust.**

Qualified charitable remainder trusts must be either one or the other in every respect. Any hybrid trust is an unqualified charitable remainder trust. Annuity trusts and unitrusts differ in the types of payout they make. An **annuity trust** provides a **fixed payout** that does not change from year to year, while a **unitrust** provides a **payout that is a fixed percentage** of the FMV of trust assets determined annually.

A charitable remainder trust must meet the definition of, and function exclusively as, a qualified charitable remainder trust from the date of its creation. Some of the requirements include:

- The trust must be irrevocable.
- At least one income beneficiary must be a noncharity and more than a de minimis amount of the income payment must be paid to the noncharity.[20] The beneficiary can be an individual, a trust, an estate, partnership, or corporation. If the noncharitable beneficiary is an individual, the individual must be living when the trust is created.

- Other than the annual payment, no other trust amounts may be paid to or available to any other noncharitable beneficiary.
- One or more charities, qualified under IRC §170(c), must be the irrevocable remainder beneficiary.
- The trust must not be subject to a power to invade, alter, amend, or revoke for the noncharitable beneficiary's benefit.
- Trust assets may not be used, or be subject to being used, for payment of the grantor's federal estate tax.
- Neither the grantor nor the charity is prevented from being the trustee, but to preclude a possible conflict of interest, neither should serve as trustee alone.[21]
- The document must not restrict the trustee's investment powers, so the trustee can invest trust assets to realize annually a reasonable amount of income and gain.
- Each contribution must qualify for either the charitable income, gift, or estate tax deductions.
- Finally, Ltr. Rul. 9547004 held that a CRUT was not a trust on formation, but an association, so had no remainder trust treatment. The trust had multiple donors which caused it to be defined as an association under Treas. Reg. §301.7701-2(a)(1). Unless a remainder trust is a trust on formation, none of the benefits are available.

The actuarial value of the charitable remainder must be at least 10% of the initial FMV of the property transferred to the trust at the time of the transfer. The 10% rule applies to each contribution of property to a CRUT. If the trust fails the 10% initially, the trust will be declared void *ab initio* or reformed to bring the value of the remainder into compliance. If the trust is declared void, no income tax deduction is allowed and any transaction undertaken by the trust will be taxed to the transferor. The CRT can be reformed by reducing the payout percentage, but not below 5%, shortening the term, or both.

Payments made to the noncharity are subject to income taxes and are taxed differently than regular trust distributions. Based on the trust income at year's end, distributions from all forms of CRTs are classified as:

- **first** — ordinary income,
- **second** — capital gain,
- **third** — other income, and
- **fourth** — corpus.[22]

Since CRT distributions are deemed to consist first of income that is taxed at the highest rate, short-term capital gains are distributed first. Next, 28% capital gains are distributed, then 25% capital gains, and finally 15% capital gains. **The trustee must report each group of long-term capital gains separately on Form 5227.** The holding period for 15% long-term capital gains is currently 12 months.

Charitable remainder trusts are exempt from taxation, unless they have unrelated business taxable income.[23] Because debt-financed income is unrelated business taxable income, the trust must not be funded with mortgaged property nor incur any indebtedness. The trust is taxable as a complex trust if it has any unrelated business taxable income. The Tax Court in *Newhall Unitrust v. Commissioner,* 104 TC 236 (1995), held that any UBTI would cause the trust to lose its tax exemption for such year, subjecting all of its income to taxation for the year. Although a charitable remainder trust is not a private foundation, certain private foundation rules apply to the trust. These rules prohibit a trust from committing acts of self-dealing or making taxable expenditures. If the trust engages in self-dealing or makes taxable expenditures, an excise tax will be imposed.

Charitable remainder trusts are tax exempt, however annual returns are required on a calendar year basis. Form 5227 is used to reflect the financial activities for the year and to pay excise taxes, if any, on prohibited transactions. Tax on unrelated business income is calculated on Form 1041. The annual filing of Form 5227 includes Form 1041-K transmittals to the trust beneficiaries. In addition, Form 1041-A, *Trust Accumulation of Charitable Amounts,* must be filed on an annual basis. The initial Form 5227 must include a true copy of the trust document.

Charitable Remainder Annuity Trusts (CRAT)

The distinguishing characteristic of a CRAT is that the annual annuity amount is fixed. When the trust is funded, the assets are valued and the annuity amount is determined. Once determined, the amount cannot be changed and must be paid every year despite circumstances. No additional contributions are allowed once the trust is initially funded. Payments must be made at least annually, but can be made more frequently.

The minimum annuity amount payable at least annually cannot be less than 5% or more than 50% of the initial FMV of the property placed in trust. The trust document must provide for payment of an annuity that is a sum certain. A sum certain exists if the annuity is:

- A stated dollar amount that remains constant for each recipient or for the total amount payable for each year of the annuity, or
- Expressed as a fraction or a percentage of the initial FMV of the property irrevocably transferred to the trust, as finally determined for federal tax purposes.

When the percentage method is used, the governing instrument must provide that if the FMV is incorrectly determined, the recipient must pay or repay any difference between the amount paid and the amount that should have been paid.

For short tax years, the annuity payment must be adjusted. The payment must be prorated by the number of days in the taxable year divided by 365, or 366 in a leap year. The same proration occurs in the year the annuity ends, and the number of days of the annuity period is divided by either 365 or 366. Instead of prorating the last annuity payment, the document can provide that the payments end with the last regular payment before termination.

When the requirements of IRC §664 are met, the donor is entitled to a deduction equal to the present value of the remainder interest. This is determined by subtracting the present value of the annuity from the net FMV of the assets transferred to the trust. IRC §7520 requires the value of annuities, life estates, term interests, remainders, and reversions be determined under IRS tables using an interest rate equal to 120% of the federal midterm rate in the month of transfer rounded to the nearest .2%. For charitable transfers, the current midterm rate or the rate for either of the two prior months may be used.

Example 16. Roger transfers $100,000 on January 1 to a CRAT. Under the CRAT's terms, the trustee must pay to Roger's daughter, Helen, $5,000 annually, with the payment due on December 31. When Helen dies, the remainder goes to charity.

In January, the IRC §7520 rate was 8.8%. Helen is 50 years old. Roger is entitled to a **charitable deduction** of **$52,070,** computed as follows:

Using the Table S annuity factor of 9.5860, the life annuity's present value is **$47,930** ($5,000 × 9.5860).

Consequently, the charitable remainder interest's present value is **$52,070** ($100,000 − $47,930).

During the following year, the CRAT income is:

$3,000 of taxable interest,

$2,500 in dividends,

$2,500 in short-term capital gains, and

$2,000 in long-term capital gains.

Helen receives $5,000, of which **$2,727 is interest income** and **$2,273 is dividend income.** Helen must pay income taxes on these amounts. The remaining taxable income is retained by the CRAT and no income taxes are paid, since the CRAT is a tax-exempt entity.

For CRATs only, a special probability rule applies. **If a probability greater than 5% exists** that an **income beneficiary of an annuity trust will survive to the exhaustion of the trust, no charitable deduction is allowable** with respect to the trust, even though the present value of the charitable remainder interest in the trust is greater than zero. The probability test has no application to unitrusts, since a unitrust cannot be exhausted. With the imposition of the 50% maximum payout limit and the 10% remainder rule, the 5% probability rule will have little effect in the future.

Charitable Remainder Unitrusts (CRUT)

Unlike a CRAT, a CRUT does not provide for a sum certain payment annually. The CRUT must make annual payments to all recipients totaling at least 5%, but not more than 50%, of the net FMV of the assets computed annually. If trust income is insufficient, payments must come from corpus. Payments must be made following the same rules that apply to a CRAT.

Net FMV can be determined on any one date during the trust's tax year, or by taking the average of valuations made on more than one date during the tax year. The same valuation date or dates and valuation methods must be used each year. If the governing instrument does not specify the valuation date or dates, the trustee must select a date or dates and show the selection on the trust's first tax return.[24] Most CRUTs select the first day of the year as the valuation date.

As with a fixed percentage CRAT, the trust's document must provide that if the net FMV is incorrectly determined, the trust will pay to or be repaid by the recipient an amount, so the recipient receives the amount he would have been paid if the assets had been correctly valued. Payments or repayments due to an incorrect valuation must be made within a reasonable period after the value of the trust assets is finally determined. A CRUT can permit additional contributions, providing the trust document contains specific provisions regarding:

- Valuation of the additional contributions and
- Computation of the unitrust amount for the trust's tax year in which the additional contribution occurs.

A unique feature of a CRUT is the right to alter when and how much must be paid currently. The document can include an income-only payout provision or an income-only-with-make-up provision. Both types of provisions effectively limit distributions to trust accounting income, other than capital gains, and prevent distributions of trust corpus. Trust income is determined under the terms of the governing trust instrument and state law.

Under an income-only provision (NICRUT), the trust pays out annually the trust income for a tax year to the extent that the income does not exceed a specified fixed percentage of not less than 5% of the trust assets' net FMV for the year. An income-only-with-make-up provision (NIMCRUT) is the same as an income-only provision, except that the trust must also pay trust income for a tax year that exceeds the fixed percentage amount to the extent that the aggregate of the amounts paid in earlier years was less than the aggregate amounts that would have been paid under the trust's fixed percentage.

Neither the Code nor the regulations authorize the use of excess income from a prior year to make up a deficiency in a future year. All precontribution capital gains must be allocated to corpus on sale. Postcontribution capital gains may be allocated to trust income if allowed by local law and the governing document.

A flip CRUT is allowed in limited circumstances. A flip CRUT is a NICRUT or NIMCRUT that holds unmarketable assets. Once the assets are sold, the NIMCRUT changes (flips) to a standard fixed percentage CRUT. NIMCRUTs or NICRUTs can become flip CRUTs, but only these types of CRUTs. A CRAT cannot be flipped into a CRUT and a standard CRUT cannot be flipped into a NICRUT/NIMCRUT. Under the final regulations, a onetime flip CRUT would be allowed when:

1. Trust assets consist of unmarketable assets — assets other than cash, cash equivalents, or marketable securities — but there is no requirement that a certain percentage of the trust consist of unmarketable assets.
2. Document must provide that the CRUT will use either the income-only or income-only-with-make-up provision until the occurrence of a triggering event:
   a. The sale of a specific unmarketable asset or group of unmarketable assets
   b. A specific date
   c. A single event whose occurrence is not discretionary with, or within the control of, the trustee or any other person (the not-considered-discretionary test)
3. Only the fixed percentage method may be adopted after the flip for calculating all remaining payments.
4. Any make-up amount is forfeited for all years after the year in which the triggering event occurs.

Example 17. Don owns farm land he wants to gift to his church, but does not want to part with all of the land's value, so he is considering a CRUT. Since the land does not produce enough income to support the necessary CRUT payments, Don decides to establish a flip CRUT.

Initially, the trust will be structured as a NIMCRUT, so any accounting income can be paid to Don. Once the land is sold and the proceeds reinvested, the trust will have sufficient funds to pay Don the full fixed percentage, so it will convert into a standard CRUT.

By establishing a flip CRUT, Don can make the gift presently, obtain a current income tax deduction, allow time to find a buyer who will pay full value for the land, and receive some payments until the land is sold.

CHARITABLE LEAD TRUSTS (CLT)

Purpose of a Charitable Lead Trust

A CLT enables the grantor to obtain a gift or estate tax deduction for the charity's interest allowing the noncharitable beneficiaries to inherit the property at a small or no transfer tax cost.

Overview

CLT is the opposite of a remainder trust. Instead of the charity receiving a remainder interest, the charity receives the income interest, while the noncharity beneficiary receives the remainder. The term **charitable lead** does not appear in the Code or Regulations, but IRC §170(f)(2)(B) and Treas. Reg. §1.170A-6(c)(2)(I) detail the main rules concerning a CLT.

Before any tax deduction is allowed, the income interest must be paid as either a guaranteed annuity (CLAT) or a unitrust (CLUT). No hybrid payments are allowed. Further, the client must choose an income tax deduction or a transfer tax deduction, because the provisions that allow one do not permit the other. The trust must be irrevocable and charitable payments can be made for either a term of years or for the life of a named individual. No restrictions are placed on the length of a term for years[25] or the percentage payment to the charity. While the document may name a specific charity or charities as income beneficiary, the document may allow the trustee to select which charity receives the income interest. The grantor should not retain the right to select or change charities or be on the charitable board that receives the interest. Allowing the grantor to decide which charity receives the distributions or how the charity will use the funds could result in the trust being included in the grantor's gross estate as a retained interest.

A CLT can be formed as either a grantor or nongrantor trust. If formed as a grantor trust, the donor is entitled to an income tax deduction. If formed as a nongrantor trust, the donor is entitled to a transfer tax deduction.

As a grantor trust, the donor will be entitled to an income tax deduction for the present value of the charity's income interest. No deduction is allowed for the annual payments to charity. Since the grantor must include the trust's income in taxable income, the grantor effectively recaptures the original deduction. Further, the original deduction is subject to the individual charitable deduction limitations and the itemized deduction restrictions. Depending on why the trust is taxed as a grantor trust, the trust assets may be included in the grantor's gross estate at death.

Finally, if the donor dies before the trust terminates, the donor has taxable income equal to the charitable income tax deduction taken when the trust was funded minus the required charitable payments that were actually made before death. The charitable payments must be discounted to the date of the contribution. The deduction must also be recaptured if the donor ceases to be subject to the grantor trust rules.

A nongrantor trust is a separate taxpaying entity. Unlike a remainder trust, a CLT is not a tax-exempt entity. A CLT is taxed as a complex trust under IRC §§641–668. IRC §642(c) allows an unlimited deduction for gross income paid to a charity under the terms of the document. Gross income means IRC §61 income. Since the amounts paid to charity are fully deductible, the CLT should owe no income taxes. If the trust earns more than the required payment, no additional deduction is allowed, even if the amounts are paid to charity. If the nongrantor CLT pays a guaranteed annuity or unitrust income interest to a charity, the present value of the income interest can be deducted for gift tax or estate tax. No minimum payment is required and the guaranteed annuity can be redetermined at the expiration of a term if the method for calculating the redetermined amount is fixed and ascertainable at the trust's creation. The grantor will have made a taxable gift to the noncharity beneficiaries, since future interests are not eligible for the annual exclusion.

Before any tax deduction is allowed, the CLT must provide for annual, or more frequent, payments to a qualified charity as either a guaranteed annuity or unitrust amounts.[26] A guaranteed annuity provides the charity a sum certain payable at least annually for a term of years or for the life or lives of individuals. The amount is determined at the beginning of the trust and cannot change during the term, except as discussed previously. A unitrust interest provides the charity a payment, at least annually, of a fixed percentage of the net FMV of the assets, determined annually. The risk in forming a charitable lead annuity trust (CLAT) is the corpus will produce insufficient income to pay the annuity; therefore, corpus will be reduced to pay the required amount. Corpus of a charitable lead unitrust trust (CLUT) is subject to reduction also, through increased interest payments and annual valuations.

A CLT is subject to certain private foundation rules. The CLT and disqualified persons are prohibited from engaging in self-dealing. In addition the trust is subject to the jeopardy investment and the excess business holdings rules. The document is required to set forth prohibitions against engaging in these activities.

Whether a CLT is right for the client depends on the numbers. The charitable deduction for income, estate, and gift taxes is the present value of the charitable income interest. If the value of the income interest is high enough, no gift tax will be due for a nongrantor CLT.

Depending on the assumptions and whether they are realized, a CLT can effectively transfer greater wealth to future generations than other trusts. An effective CLT uses a large charitable payout to reduce the remainder interest to zero. The IRS holds that only the remainder of a specific term CLT can be reduced to zero.[27] A zero remainder value occurs when the annuity payments are set for a sufficiently long period and at a high payout rate, so the value of the charitable interest absorbs the entire transferred property value. These values are affected by the IRC §7520 rate. Like remainder trusts, the value of the interests in a CLT is determined according to the Tables under IRC §7520.

As a wealth planning tool, a CLT works when the growth of the trust assets exceeds the IRC §7520 rate. To ensure a zero remainder for a CLAT, a percentage should be used to figure out the payout instead of a fixed dollar amount. If the IRS revalues the transferred assets, the annuity payment will automatically be adjusted by any change in the value of the transferred assets. Since the IRC §7520 rate and term remain constant, the remainder will still be zero. A fixed dollar payout cannot be adjusted by any revaluation of the transferred assets, so if the assets' value is increased, the value of the remainder will absorb most of the increased value. With the potential repeal of the estate tax, the future use of a CLT is debatable.

ENDNOTES

1 A truism of estate planning is: "Dead people do not own stuff!"

2 The Uniform Principal and Income Act has been revised twice; therefore, some states follow the original 1931 Act while other states followed the 1962 Revised Uniform Principal and Income Act or the 1997 Uniform Principal and Income Act. While a state may have adopted a particular Act, it may not have adopted the uniform act in its entirety. State law must be examined to determine exactly how the trust should allocate principal and income for trusts governed by that state's laws.

3 The chapter discusses the Uniform Principal and Income Act. There exist three different versions of the UPIA. One was adopted in 1931, another in 1962, and the most recent version in 1997. Which Act applies depends on which Act has been adopted by the particular state under which the trust operates. The following state follows the 1931 UPIA: Vermont.

In 1962, the Revised UPIA was drafted. The following states have adopted the Revised UPIA: Alaska, Delaware, Georgia, Illinois, Kentucky, Louisiana, Michigan, Mississippi, Montana, Nevada, North Carolina, Oregon, South Dakota, Texas, Utah, and Wisconsin.

In 1997, a completely new UPIA was drafted. The following states have adopted the 1997 UPIA: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, District of Columbia, Florida, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Maryland, Minnesota, Missouri, Nebraska, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Virginia, Washington, West Virginia, and Wyoming. Alaska, Montana, Nevada, North Carolina, Oregon, Rhode Island, Texas, Vermont, and Wisconsin will be considering adopting the 1997 Act during 2003.

Allocating inflows between income and corpus is mandatory to maintain the viability of the entity. While a state might not have enacted either the 1931, 1962, or 1997 UPIA, every state has some method of performing the allocation. Further, each state may not have enacted the model Acts in their entirety. The guidelines discussed in the chapter provide a framework for understanding how allocations are performed whether a particular state follows the UPIA or not. A complete discussion of trust allocation is beyond the scope of the chapter, so the laws of the state governing the trust must be reviewed to determine exactly how a trust should perform the required allocations.

4 A pour-over will has all of the probate assets distributed to the trust. Since most people fail to transfer all assets during life to the living trust, some assets must go through probate before title can be changed. By having a pour-over will, any assets not transferred to the trust during life will go through probate, be transferred to the trust, and be distributed according to the trust's terms. This avoids having assets not transferred into the trust during life from being distributed pursuant to the intestacy laws.

5 IRC §645 was added by the 1997 Tax Act, which allows revocable trusts to be included with the probate estate and taxed as an estate. While most of the differences between the income taxation of trusts and estates have been removed, by electing to combine the activities of the revocable trust and probate estate, reduced paper work and administrative costs are available. Only revocable trusts under IRC §676 can make the election and the election must be made by both the estate and trust.

6 IRC §2056A states that no marital deduction for transfers to non-U.S. citizens for estate tax purposes is allowed unless the property is left in a Qualified Domestic Trust (QDOT). The purpose of the trust is to ensure collection of FET on marital deduction property intended for the benefit of a spouse who may have no legal or geographical ties to the U.S. A discussion of the requirements for a QDOT is beyond the scope of the chapter.

7 A bypass trust may be referred to as a "B" trust. The reason for calling the trust a bypass trust is because the property and all appreciation in the trust by passes S_2's gross estate. With the change in terminology, a bypass trust that shelters only the applicable credit is called an "exclusion trust" instead of a credit shelter trust. Since our discussion does not limit the bypass to only the applicable exclusion amount, use of the term "bypass" trust is still appropriate.

8 *Estate of Vissering v. Commissioner*, 990 F2d 578 (10th Cir, 1993) held that state law can be used to determine if a POA is either a GPOA or one limited by an ascertainable standard. The 10th Circuit ruled Florida law would interpret "comfort" to limit Mr. Vissering's ability to invade corpus, so his power was limited by an ascertainable standard. The IRS held in Ltr. Rul. 9125002 that "comfort" did not sufficiently limit the power to invade, so the holder had a GPOA. In *C.B. Forsee v. U.S.*, 2001-1 USTC ¶60,396 (DC KS), the district court held that "happiness" did not sufficiently limit the invasion power under state law, so the holder had a GPOA. While state law can be used to determine if the provision is an ascertainable standard, planners can avoid any question by using only those words found in the Regulations under IRC §2041.

9 IRC §2056(b)(7)

7

10 The term Crummey comes from the case *Crummey v. Commissioner*, 397 F2d 82 (CA-9th, 1968). The term refers to a withdrawal power given to the beneficiaries. The trust beneficiaries are given the right to withdraw the lesser of the amounts contributed or the annual exclusion for a limited time. Since a Crummey power is a GPOA, the donor has made a present interest gift, which would qualify the property subject to the Crummey power for the annual exclusion.

11 In community property states, neither spouse should be trustee. The proceeds being transferred into trust are normally community property. As such, both spouses own the assets being placed into trust. Under Rev. Rul. 84-179, the trustee will be attributed incidents of ownership if she provided the property placed into trust and can personally benefit from the powers as trustee. Preventing inclusion in either spouse's estate requires a complete separation from ownership in the policies.

12 Treas. Reg. §20.2042-1(b)(1)

13 The trust can include a contingent marital deduction clause. If the proceeds are included in the grantor's gross estate, due to the three year rule, the proceeds would be paid to the estate instead of the trust, and be paid outright or in trust to the surviving spouse. If the grantor lives longer than three years, the proceeds would be paid to the trust and be distributed under its term, avoiding inclusion in either the grantor's or the spouse's gross estate.

14 IRC §677(a)(3)

15 If there is an informal agreement between the grantor and the third party, the grantor can be attributed ownership of the property contributed resulting in taxation.

16 No distributions are allowed until after the grantor's death. Although the beneficiaries received their interests presently, since the assets are not currently enjoyable, all interest are considered future interests.

17 Rev. Rul. 67-241, 1967-2 CB 225 and Private Ltr. Ruls. 8142061 and 8326074.

18 While a shorter term GRAT would be even better, the Code and Regulations may be interpreted to require at least a 2-year term. IRC §2702(b)(1) states that a qualified interest is "the right to receive fixed **amounts** payable **not less frequently** than annually." A 2-year term has two payments, so the GRAT will pay two amounts.

19 The regulations are silent concerning the consequences if the trustee or beneficiaries decide not to follow the trust's provisions. This is an anomaly of the qualified interest trust regulations also.

20 If all the beneficial interests of the trust are held by charities, the trust is a charitable trust under IRC §4947(a)(1) instead of an IRC §664 trust.

21 The IRS takes the position that if an understanding exists between the trustee and the grantor for the trustee to sell the property transferred to trust, the gain will be taxed to the grantor. If the grantor is the trustee, the grantor will have a difficult time convincing the IRS that no understanding existed; therefore, use of an independent trustee is highly recommended. Further, if the trust's income is taxed to the grantor under the grantor trust rules, the CRT will be disqualified. Rev. Rul. 77-73, 1977-1 CB 175 and 77-285, 1977-2 CB 213.

22 If a charity is an income beneficiary also, distributions to the charity are deemed to come in reverse order from that to a noncharitable beneficiary. Treas. Reg. §1.664-1(e)(1).

23 Treas. Reg. §1.664-1(a)(1). Remainder trusts are referred to as "tax-exempt split interest entities" also. If the CRT does not meet the maximum payout rules, the CRT will be taxed as a complex trust.

24 Treas. Reg. §1.664-3(a)(1)(iv). The Service has provided a method of computing the net FMV when the annual valuation date is not the first day of the trust's tax year and when one or more payments of the unitrust amount have been made prior to the annual valuation date. Rev. Rul. 76-467, 1976-2 CB 198.

25 The trust must meet the state law requirements for a trust. One of these requirements is the rule against perpetuities. A trust must terminate within the perpetuities period or be subject to termination. To avoid the rule, either a perpetuities limitation can be added to the document or the trust can be created in a state that has a longer period in gross (90 years under the Uniform Statutory Rule Against Perpetuities) or no rule against perpetuities.

26 Treas. Reg. §25.2522(c)-3

27 Rev. Rul. 77-454, 1977-2 CB 351