Trusts, Trusts, Trusts: Which One to Use, What Does It Do and How Does It Work.

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OVERVIEW

A phrase used by many attorneys in the estate planning field is "We can use a trust to . . . . . ." The blank may be filled in with any number of goals or objectives of the client as we will see once we are aware of the many types of trusts that may be used. The trusts discussed in this article do not include every type of trust that can be created nor does the article discuss various types of trusts in intimate detail with special nuances and tweaks. The purpose is to illustrate how certain commonly used trusts work, to explain the benefits each particular form of trust offers, and to gain an understanding of which trusts can accomplish the client's goals.

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TRUST BASICS

A trust is created when a Grantor (who may also be called a Settlor, Creator, or Trustor) names a beneficiary or beneficiaries to receive the beneficial interest of a *res* (Latin for property) and actually delivers the *res* to a Trustee. The Trustee should also accept the *res*, but acceptance of the *res* is presumed under the law. Generally, the Grantor provides instructions to the Trustee regarding the interests of the beneficiaries and how the trust may operate administratively. Although some states may allow oral trusts, almost all trusts are created by a written document, which may be referred to as a Trust Agreement, Trust Instrument or Trust Indenture. Some attorneys say an oral agreement or trust is not worth the paper it is written on.

The Grantor of the trust must be of legal age and mental capacity to enter into a contract. This standard is higher than the capacity to make a Last Will and Testament, which in most states only requires an understanding of the property one owns and who the natural objects of one's bounty are. Trusts are generally created by one or two Grantors, although transferors to the trust other than the initial Grantor(s) may also qualify as Grantors for income tax purposes.

The Grantor may name as trust beneficiaries individuals or entities such as charities. Sometimes individual beneficiaries are not named specifically, but are named as a class. An example of this would be to name "my grandchildren, in equal shares." More importantly, the trust will usually have two types of beneficial interests: an income interest (which may be based on a lifetime or term of years) and a remainder interest. For example, a trust may provide for the income of the trust to be paid to a spouse for his or her lifetime. Upon the spouse's death, the trust may provide that the remaining assets of the trust, called the remainder, will be paid to the Grantor's children, who are called the remaindermen.

An important requirement of creating a trust is the necessity of having a *res*, or property subject to the trust. Some asset must exist which is subject to the trust's terms; otherwise there will be no trust. The *res* can be any type of property transferred to the trust, whether it be cash, marketable securities, personal property, real property or property in any other form. In many trust agreements, there will be an Appendix that reflects the property

transferred to the trust, usually $10 or $100 in cash, at the time of execution of the trust instrument. Other property transferred after the execution of the trust is shown as subsequent contributions to the trust in the Appendix.

The Grantor in creating the trust will name a Trustee to administer the trust according to the terms the Grantor has specified. The Trustee is a fiduciary who must act in the best interest of the beneficiaries at all times. He will be responsible for safeguarding the trust property, investing it, and making distributions according to the trust's terms. He will also be required to account to the beneficiaries periodically for the financial decisions made during the trust's administration and must complete a final accounting to the beneficiaries which they must approve before the Trustee is discharged. Of all the requirements of creating a trust, the naming of a Trustee is one that may be omitted without jeopardizing the creation of the trust, since no trust will fail simply because a Trustee is not appointed. If the instrument does not name a Trustee or a successor Trustee, the power to appoint a Trustee rests with the appropriate state court, which New York is the Supreme Court or Surrogate's, Court in. [1]

Lastly, the Grantor must deliver the *res* to the trustee. If the Grantor does not deliver the *res* to the Trustee, there is no trust created since the *res* remains under the dominion and control of the Grantor. Acceptance of delivery is presumed unless rebutted.

Inter Vivos Trusts and Testamentary Trusts

Trusts can be created either during the lifetime of the Grantor (Inter Vivos Trusts) or at death via a Last Will and Testament (Testamentary Trusts). An Inter Vivos Trust created by the Grantor may be either Revocable or Irrevocable, depending on its terms. It usually takes the form of a written trust document (contract) that outlines the terms of the trust including its beneficiaries, the Trustee or Trustees and the beneficial interests of the income beneficiaries and remaindermen. The Trust document It will also generally state whether it the trust is Revocable, which would allow the Grantor to alter, amend, terminate, or revoke the trust in part or in its entirety, or Irrevocable, which would allow no such powers to be retained by the Grantor. A Testamentary Trust would be an Irrevocable Trust (absent a successful séance recognized by the Court) created by the Grantor's Last Will and Testament. In order to create the Testamentary Trust, the Grantor's Last Will and Testament must be probated in court. It is only after the probate process is complete that the court will issue Letters of Trusteeship to the Trustees, thereby creating the trust.

Revocable and Irrevocable Trusts

As stated above, Inter Vivos Trusts may be Revocable or Irrevocable. An Irrevocable Trust explicitly states that the Grantor may not alter, amend, terminate or revoke any part of the trust created. This provision also allows the Grantor to avoid inclusion of the trust assets in his estate.[2] A transfer of property to an Irrevocable Trust is considered a gift since the Grantor is giving up complete dominion and control over the property by transferring the property to another party, the trust. Insofar as the purpose of an Irrevocable Trust is to remove assets from the Grantor's estate, the trust will generally not name the Grantor as a beneficiary or Trustee of the trust, which may cause inclusion in the Grantor's taxable estate.[3]

[1] New York Surrogate's Court Procedure Act § 1502. Other states may have similar statutes.

[2] See generally, IRC § 2038

[3] See generally, IRC § 2036

A Revocable Trust satisfying the requirements for creating a valid trust usually reserves to the Grantor the ability to alter, amend, terminate or revoke the trust in part or in its entirety. This language must be explicit in the document creating the trust. If a trust is not specifically made Revocable, it is Irrevocable.[4] Further, the Grantor is usually a primary beneficiary of the trust and may also serve as the Trustee. Insofar as the purpose of an Irrevocable Trust is simply to hold assets while allowing the Grantor discretion to enjoy the benefits of the property, the creation of the trust does not result in a gift being made since the Grantor can change the rules at any time and has access to the trust assets.

There has been a shift in the use of Revocable Trusts as estate planning aids over the past two decades. These Trusts are sometime referred to as Living Trusts. The Revocable Trust generally serves the some purpose as a Last Will and Testament and disposes of the trust assets in the same way as the Last Will and Testament. Advocates for using the Revocable Trust as the primary estate planning document tout several advantages of using the Revocable Trust. They include avoiding the probate process, avoiding probate fees, avoiding undue delays in administration, easing transition in the case of disability and maintaining privacy. This author, an attorney admitted to practice in the State of New York, is of the opinion that a Last Will and Testament and Durable Power of Attorney is a preferred approach to estate planning rather than a Revocable Trust, except in certain limited situations discussed later in this article.

Avoiding the probate process with its attendant probate fees may be a major consideration in Florida and California, but it does not necessarily hold true in New York. It is the author's understanding that the probate process in these two states both lengthy and expensive, which has not been the author's experience in the New York City area. In New York the probate process usually requires a probate petition to be filed with the Surrogate's Court together with Waivers of Citation executed by the decedent's distributees at law. In normal circumstances, the spouse is the petitioner/executor and the children are required to execute the Waivers of Citation. Although other documents may be necessary to file the petition. An attorney may charge $1,500 to appointing the Executor of the estate. Of course, should problems arise or the facts be more complicated, this estimate of attorney fees will be sure to rise. There will also be a probate filing fee, which in New York is $1,250 if the value of the estate is $500,000 or greater.[5] The attorney's other work in administering the trust or estate will be similarly priced. The assets must be gathered, valuations obtained, tax returns filed and accountings approved. The so-called tremendous savings in "probate fees" may, in fact, be minimal. And remember, the attorney may well charge $1,500 to $2,500 for drafting a Revocable Trust, which would offset the approximate cost noted above to probate the Last Will and Testament.

Further, in order to avoid the probate process, all of the decedent's assets must be transferred to the trust or be non-probate property. For example, the decedent may have one $55,000 bank account in his name that he didn't transfer to the Revocable Trust. In that case, a Last Will and Testament must be probated. And even if all existing assets are properly titled in the Revocable Trust, there still may be a probate asset in the estate. A good example of this would occur if the decedent died in an accident caused by another party. The lawsuit would have to be brought by the

[4] New York State Estates, Powers and Trusts Law § 7-1.16.

[5] New York State Surrogate's Court Procedure Act § 2402. For estates valued at less than $10,000, the fee would be $45, for estates valued between $50,000 and $100,000, the fee would be $280 and for estates valued between $250,000 and $500,000, the fee would be $625.

estate's Executor, which of course would necessitate probating the decedent's Last Will and Testament.

There are no income tax savings associated with the use of a Revocable Trust. For income tax purposes, it is treated as a Grantor Trust, which requires all income and deductions to be reported on the Grantor's individual tax return. There are also no estate tax savings since the Grantor retains control and beneficial enjoyment of the trust assets, which causes the assets of the trust to be included in the Grantor's gross estate. The trust may have provisions to take advantage of certain estate planning techniques, such as the creation of a Credit Shelter Trust or Q-TIP Trust, which are discussed later in this article.

The ability to avoid undue delays in administering the estate by using a Revocable Trust may also be questionable. Obviously, if there is a dispute between the beneficiaries, the administration of both an estate and a trust will be drawn out because of the dispute. In those cases where "everyone is in agreement," it becomes a question of how long a delay may be before it is considered "undue." Most estates take from eighteen months to three years to complete.[6] The reason it may take this long is that the estate's estate tax returns (both Federal and state) are due nine months from the decedent's date of death (without extensions). It may take one to two years before the IRS issues what is know as a "closing letter," stating the return was received and accepted as filed. Another possibility (and not a good one) is that the IRS may select the estate tax return for audit, which would further delay the issuance of the closing letter until after the audit's conclusion. Many attorneys delay distribution of the estate until the closing letter is received because it is preferable to keep the assets in the estate rather than chasing beneficiaries for the assets should more taxes be due. This analysis would be equally applicable to administration of a Revocable Trust. As mentioned earlier, there is still an estate tax return to be completed and filed and attorneys would generally prefer to retain the assets in the trust until such time as the closing letter is received. It seems to this author that, all things being equal, the distribution of the assets from the estate or Revocable Trust would generally take the same amount of time.

Advocates for the use of a Revocable Trust stress the ability to have a successor Trustee step in should the Grantor/Trustee become disabled or incompetent, such power being specifically included in the Revocable Trust. This can avoid court involvement in appointing a Conservator or Committee to handle the affairs of the disabled/incompetent individual, which is unduly burdensome and expensive. However, the same result can be obtained if the client executes what is known as a Durable Power of Attorney (DPOA).[7] A DPOA appoints another individual to act in the client's place and stead to handle all types of transactions even if the Grantor becomes disabled or incompetent.

The last and, in this author's opinion, the least, benefit of using a Revocable Trust is the ability to keep one's affairs private. The probate of a Last Will and Testament in a Surrogate's Court is a public proceeding and anyone can examine the court file, which would identify the size of the estate (and possibly the details of its assets and liabilities) and the names of its beneficiaries. Unless you are a celebrity, there is a question of who would be interested in such information. With that being said, a Revocable Trust may not provide the privacy anticipated by its use.

[6] This has been the author's experience although one simple estate was closed within one year and another more complicated estate was administered for 14 years before closing.

[7] See generally, New York State General Obligations Law § 5-1501

If there is a dispute which results in a lawsuit regarding the trust, the trust instrument in all likelihood will be included with court papers which are also available to the public, so its content would no longer be private.

One other item that will affect the use of a Revocable Trust is whether it can be challenged due to a lack of capacity, similar to a challenge to a Last Will and Testament. In general, mental capacity to make a Last Will and Testament requires only that the maker know the extent of his property and who the natural objects of his bounty are. It has been held that "less capacity is required to make a will than to make another contract."[8] Therefore, it may prove easier to show the lack of capacity of the Grantor of a Revocable Trust than of a maker of a Last Will and Testament, since the standard is higher for entering a contract (the trust) than for making a Last Will and Testament.

There are however, viable reasons for using a Revocable Trust other than those discussed above. One such reason is the ownership of real property in several states. Upon the decedent's death, there will be the probate of his Last Will and Testament in his state of domicile and there will be necessary ancillary probate proceedings in each state in which he owned real estate. Each state retains jurisdiction over the transfer of real property in that state and other state courts cannot effect transfers for real property outside state borders. Placing the real estate in the Revocable Trust, would allow the transfer of the real property pursuant to the Revocable Trust without the added cost of an ancillary probate in another state. Another valid reason for creating a Revocable Trust to effect the testamentary transfer of property would be inability or difficulty in locating the heirs at law of the decedent. For instance, the closest living relatives may be cousins (on both the maternal and paternal lines) who may not be easily identified and/or found. A genealogical tree would be required to identify them and they would have to be located. Failing that, the court might allow notice to them via publication, a timely and costly procedure. A Revocable Trust would avoid this difficulty.

[8] Matter of Coddington, 281 App. Div. 143, 118 N.Y.S.2d 525 (3d Dept. 1952), *aff'd*, 307 N.Y. 181, 120 N.E. 777 (1954).

Types of Trusts

Credit Shelter Trusts. These trusts are also know as By-Pass Trusts and are usually created in a Last Will and Testament. The trust hold asset for the benefit of a spouse and/or other beneficiaries and is designed to expose the trust assets to estate taxation. Of course, the amount exposed to taxation is usually limited to the amount of property sheltered from estate taxation by the applicable exclusion credit/unified credit so no actual tax is generated. The use of this trust allows the surviving spouse to avoid having the assets in this trust included in his or her estate so that both the husband and wife can utilize their individual credits, reducing potential estate taxes and increasing the amounts passing to their beneficiaries.

There is tremendous flexibility in drafting this trust. The trust may provide that the income of the trust must be paid to the surviving spouse quarterly. This insures that the spouse will at least receive the income from the trust automatically. The trust could also provide for discretionary distributions of trust principal as the Trustee may determine to or for the benefit of the spouse. However, if the spouse does not need the principal or income of this trust because other assets may be available to him or her, it would be prudent to have the income distribution to the spouse be in the discretion of the Trustee so the income would not have to be distributed to the spouse and thus be includible in his or her estate. It is also possible to give the spouse a 5 and 5 power, which gives the spouse the ability for the spouse to withdraw from the trust the greater

of $5,000 or 5% of the value of the trust. This insures that the spouse can receive this amount of principal from the trust without the exercise of discretion by the trustee. Another alternative would be to give the trustee discretion to distribute income to a class of income beneficiaries consisting of the spouse and children. This would allow for discretionary distributions of income to be made directly to the children if needed without the surviving spouse using his or her annual gift tax exclusion or lifetime gift applicable exclusion credit. Distributions of principal could also be made to the children in the Trustee's discretion.

Drafting for a Credit Shelter Trust is now proves tricky due to EGGTRA 2001. The applicable exclusion credit for estates increases to $1.5 million in 2004 and 2005, increases to $2 million in 2006-2008 and to $3.5 million in 2009. It also regresses to $1 million in 2011 following the one-year estate tax repeal in 2010. This presents a quandary for clients since they may want a credit shelter of $1.5 million but not one of $3.5 million, depending on the size of their estate. Most estate attorneys drafted these trusts with a formula allowing the full amount of assets sheltered under the credit to pass to these trusts, which may no longer be the client's desire. This requires a detailed discussion between the attorney and client to ascertain what best suits the situation.

QTIP Trust. The QTIP Trust, which stands for Qualified Terminable Interest Property Trust, allows property passing to it to qualify for the estate tax marital deduction (provided the surviving spouse is a U.S. citizen). In order for the trust to qualify, it must provide that 1) the surviving spouse is entitled to all trust income payable at least annually and, 2) no person has a power to appoint any part of the property to any person other than the surviving spouse. 3) The assets of the trust are included in the surviving spouse's estate and the Executor must make an election on the estate tax return electing QTIP treatment for the trust.[9] The Trustee may also have the discretion to distribute principal to the surviving spouse without jeopardizing the QTIP election. The remainder beneficiaries are named by the decedent and not by the surviving spouse. This allows for the decedent spouse to insure any principal of the trust remaining after the surviving spouse's death will be paid to the beneficiaries the decedent spouse designates. The use of this trust is particularly useful in second marriage situations where, for example, a husband wishes to provide for a second wife during her lifetime but also wants to insure that his assets are not totally consumed by his second wife or passed to his second wife's second, third or fourth husband. Although the Trustee may make discretionary distributions to the spouse, the Trustee also owes a fiduciary obligation to the children remaindermen to protect their interest unless the trust terms allow otherwise. The Trustee could be someone who may be objective but empathetic to the situation, such as the decedent's brother (as long as he doesn't become the second wife's second husband). This trust could also be used to provide the necessary oversight of the trust assets if the surviving spouse is not up to the task of managing, investing and preserving assets.

GPA Trust. The GPA Trust, which stands for General Power of Appointment Trust, is also a trust that allows property passing to it to qualify for the estate tax marital deduction (provided the surviving spouse is a US citizen). The trust must provide that 1) all income will be payable to the surviving spouse payable at least annually; 2) no person has a power to appoint any part of the property to any person other than the surviving spouse; and 3) the spouse has the power, exercisable in all events, to appoint the property to him or herself or to his or her

[9] IRC § 2056(b)(7)

estate.[10] Unlike the QTIP Trust discussed above, here the surviving spouse can appoint the property to whomever he or she wishes, including a future spouse. The decedent in creating this trust allows the surviving spouse to distribute the assets as he or she sees fit. Obviously, the decedent trusts the surviving spouse to take care of the children after decedent's death. The surviving spouse's flexibility in appointing the property as he or she sees fit will allow distribution of the property to the children in whatever manner the surviving spouse determines to be best for all concerned. For instance, one child could be very well off and not need an inheritance while the other children might require financial assistance. The surviving spouse may distribute the assets unequally to the children, even leaving one or more out entirely, or giving all trust assets to one child. It should also be noted that the general power of appointment is usually testamentary in nature, exercisable in the surviving spouse's Last Will and Testament. It would make little sense to have the general power of appointment exercisable by the spouse during his or her life since the spouse could just take the property outright, thus defeating the purpose of the trust.

QDOT Trust. The QDOT Trust, which stands for Qualified Domestic Trust, allows property passing to it to qualify for the estate tax marital deduction where the surviving spouse is not a US citizen. Property passing to a non-citizen surviving spouse is not otherwise eligible for the federal estate tax marital deduction.[11] In order to claim a federal estate tax marital deduction for property passing from a decedent to a QDOT, the trust must otherwise qualify for the marital deduction under section 2056(b)(5) (life estate with power of appointment) or section 2056(b)(7) (qualified terminable interest property, including joint and survivor annuities under section 2056(b)(7)(C)), or other applicable marital deduction sections. Other conditions also apply. The trust instrument must provide that 1) at least one trustee is a U.S. citizen or domestic corporation[12]; 2) no distribution (other than a distribution of income) may be made from the trust unless the U.S. trustee has the right to withhold the estate tax due on such distribution[13], 3) the trust must meet the requirements of any regulations issued to insure collection of any estate taxes imposed on the trust[14]; 4) and the executor must elect QDOT treatment of the trust when filing the estate tax return.[15]

The use of the QDOT allows the deferral of estate tax until such time as the surviving spouse dies, similar to the effect of the regular estate tax marital deduction, as long as distributions from the trust are exempt distributions. Exempt distributions include 1) distributions of income and 2) distributions of principal due to hardship.[16] If there is a distribution of the trust assets that is not exempt, an estate tax on such distribution must be withheld by the trustee and paid to the IRS.[17] Upon the surviving spouse's death, the assets of the trust are subject to estate tax computed on the decedent's tax base, not the surviving spouse's tax base.[18] The estate taxes would also be due upon disqualification of the QDOT.[19]

Lastly, the QDOT may be created in the decedent's Last Will and Testament or may be created by the surviving spouse or the decedent's executor following the decedent's

[10] IRC § 2056(b)(5)

[11] IRC § 2056(d).

[12] IRC § 2056A(a)(1)(A).

[13] IRC § 2056A(a)(1)(B).

[14] IRC § 2056A(a)(2).

[15] IRC § 2056A(a)(3).

[16] See generally, IRC § 2056A(b)(3). This section also provide for other distributions that may be exempt.

[17] IRC § 2056A(b)(1)(A).

[18] IRC § 2056A(b)(1)(B).

[19] IRC § 2056A(b)(4).

death.[20] If the decedent did not create a QDOT in his Last Will and Testament, the ability of his executor or surviving spouse to create a QDOT will help preserve the marital deduction. Of course, the assets left to the surviving spouse would have to be transferred or assigned to the QDOT to qualify, the assets for the estate tax marital deduction, and this must be accomplished prior to the filing of the decedent's estate tax return.[21]

For a more detailed explanation of QDOTs, please see Guardian Sentinel, vol.1, no. (Summer 2000)

Trusts for Children. A trust for a child or children may be created as an Inter Vivos Trust or Testamentary Trust. An individual may wish to create a trust to provide for a child or children until they reach maturity, which is a subjective determination that will vary from family to family and child to child. Trusts are most often used for children who are minors, incapable of owning assets until they reach the age of majority, which in most cases is the age of eighteen. The Trustee would invest the assets and pay in most cases, income and/or principal for the benefit of the child. However, most trusts created for minors do not end at the age of eighteen. In fact, this author has seen trusts created for "children" who do not receive the remainder of the trust assets until the age of fifty. Generally, a trust would be created for a child with the Trustee distributing income and principal on a discretionary basis until the child attains predetermined ages. For example, a beneficiary of a trust could receive one-third of the trust corpus at the age of 25, the second one-third at age 30 and the remaining one-third at age 35. Most individuals would not want to provide large sums of money to an eighteen year old who might very well abandon the pursuit of education to "discover oneself,"[22] purchasing fast sports cars and, wrecking the same until the money runs out. The idea here is that by the age of 25, the child may have sowed his or her wild oats and be more responsible and able to handle part of the inheritance, perhaps getting married and starting a family. In theory, the child should have had completed his or her education and embarked on a career. And the child will only receive one-third of the trust assets, with two-thirds remaining for future distributions. At age 30, the child will receive another one-third distribution, hopefully having become more mature and fiscally responsible. The child would receive the last share of trust assets at 35, thus giving him or her three bites at the apple. If he can't handle fiscal responsibility by age 35, would he or she ever be able to do so? These types of provisions are designed to protect the child from himself or herself. However, if the child was responsible and needed the funds at earlier dates, the Trustee could be empowered to make substantial distributions of the trust assets even to the extent of making a full distribution if in the Trustee's opinion it was warranted. This flexibility is what makes the trust so attractive. The ages selected are up to the Grantor. They could be ages 21, 25, and 30, 30, 35 and 40 or even 42, 44, 46, 48 and 50. This author had one client who 15 years ago had trust payouts at ages 32, 34, 36, 38 and 40. Five years ago, we upped the ages to 42, 44, 46, 48 and 50. Why? The kids were now 10 years older and the client still couldn't see them handling the money. No doubt he will change the ages to 52, 54, 56, 58 and 60 in five more years, since he believes his children will never be ready.

However, in some cases a grantor may expect that a child will never have the skills necessary to control large sums of money. If this is the case, it may be possible to give that child only an income interest (discretionary lifetime

[20] Reg. 20.2056A-4(b)(1)

[21] IRC § 2056(d)(2)(B)(i)

[22] Some parents may call this becoming a no good bum.

distributions of principal to the child may also be allowed) with the remainder payable to his or her children. This type of trust will be discussed below under Dynasty Trusts.

Another decision to be made by the Grantor is whether to provide separate trusts for each child or create one big trust with all the children as beneficiaries. Each of these options has advantages and disadvantages.

Separate trusts (or shares of a trust) for each child allow each of the children to be treated equally by receiving a defined share of the trust estate. This would involve splitting the trust estate into separate parts from which each child would receive income and distributions of principal, either as discretionary distributions from the Trustee or at the ages set forth in the trust. No child could receive more than the amount in his or her trust. This treats all the children equally but does not allow for differences in the situations of the children. A more needy child would be limited to his or her share in the trust while a child who was independently successful would receive the same amount. There is no mechanism to "shift" trust assets or income to the more needy child. Some individuals prefer this method since all children are treated equally and the child who is successful is not penalized for his success. Conversely, the child who may need access to additional assets is prevented from receiving them unless they are gifted to him by his siblings.

One trust for the benefit of all the children allows the trustee flexibility in administering the trust. The trust may provide for discretionary distributions of income and/or principal to any one or more of the children in equal or unequal shares, even giving distributions to one of the children to the exclusion of the others. This puts the Trustee in the position of a parent who may wish to help the child or children who need the assets more than the other children. This is sometimes referred to as a "sprinkling trust" since the Trustee can "sprinkle" the income and/or principal among the beneficiaries in equal or unequal amounts, even giving distributions will to one child while excluding the others. It is even possible that no distributions will be made to the children from the accumulated income if the Trustee does not deem any of the children worthy of a distribution. [23]

Another type of trust is the "spray trust", a spray trust requires all income of the trust to be distributed at least annually to its beneficiaries. It may be paid in equal or unequal amounts to one, some or all or the beneficiaries. This mandatory distribution of income would insure that the income of the trust is paid out and will avoid accumulation of income in the trust and trust payment of income taxes by the trust. The "spray power" for the income can be supplemented with a "sprinkle power" for the trust's principal, thus allowing the Trustee to make discretionary distributions of income and principal as the trustee sees fit as long as all the income is distributed to one or more of the beneficiaries.

GSTT or Dynasty Trust. The Dynasty Trust is a trust that is created to benefit more than one generation and is designed to avoid the Generation Skipping Transfer Tax (GSTT). The GSTT an additional system assesses a tax on generation skipping transfers, that is to say those transfers to beneficiaries more than one generation down from the transferor, such as transfers from a grandparent to a grandchild. These trusts may be Inter Vivos or Testamentary.

For example, a Grantor may create a trust that provides for the income of the trust to be paid to his or her children for their lifetimes with income and principal thereafter being

[23] This may be a costly choice since the brackets for income taxes for a trust, in 2004 hit the top bracket of 35% for income over $9,550. See IRC §1(e).

paid to the children's children, the Grantor's grandchildren. In fact, it may be possible to keep the trust assets in the family by providing that upon the grandchildren's deaths, payments would continue to their children.[24] This type of trust will create a "family bank" that can be used by future generations. The benefit of setting up such a trust is that it would allow the family to avoid the layers of estate tax that would be paid by successive generations if each generation received the assets and passed them on to their children. In other words, rather than leaving assets to one's children and paying an estate tax, and then having the children leave those assets to their children and pay an estate tax, one could avoid the cost of the second (and third, etc.) estate tax by "skipping" that generation.

Congress recognized this loss of potential tax revenue and enacted the GSTT.[25] As of 1986, each individual had a GSTT exemption of $1 million,[26] indexed for inflation. Any transfer in excess of this exemption was subject to a GSTT, which was a flat tax based on the highest marginal estate tax rate.[27] It should also be noted that the GSTT was payable in addition to the estate or gift tax that would be due on the transfer. The GSTT prevents taxpayers from passing their entire estates to future generations tax free.

There is a potential trap in using trusts for your children when GSTT may apply which may affect those who have given little thought to addressing GSTT issues. For example, a Grantor may have a $5 million estate, which he wants to leave to his three children who are currently ages 21, 23 and 25. He sets up three trusts in his Last Will and Testament, instructing that income and principal be paid to the beneficiaries in the Trustee's discretion and that the remainder be paid to them in equal shares at the ages of 25, 30 and 35. The trust also states that should any child die before receiving full distribution of his or her trust, the trust assets shall be paid to that child's children. These are common trust provisions. If any child has children and dies before full distribution of his or her trust, that would be a taxable termination,[28] which would subject the assets the GSTT. Assuming that $1 million would go into each of the three trusts (the other $2 million having been used to pay estate taxes, debts and administration expenses), this could present a problem. The Grantor would only be able to apply his or her GSTT exemption ($1.5 million in 2004) to a portion of each trusts and the balance would be subject to GSTT at the top estate tax rate (48% in 2004). This is an unintended and costly result.

Some draftsmen of trusts provide for the creation of what is called Exempt and Non-Exempt trusts for GSTT purposes. In the above examples, each of the trusts for the children would be split to create an Exempt Trust for $500,000 and a Non-exempt Trust for the balance.[29] This would allow the assets of the Exempt Trust to pass to the child's

[24] Many states do not allow this type of transfer. In states, which have enacted a Rule Against Perpetuities law, trust assets must be distributed after a period that is measured by lives in being at the time the trust is created plus 21 years. Other states, do not have such a law and allow subsequent interests to pass to further descendants without this limitation.

[25] The GSTT was originally created by the Tax Reform Act of 1976 and totally revamped by the Tax Reform Act of 1986.

[26] EGTRRA 2001 increased the amount of the GSTT exemption to $1.5 million in 2004-2005, $2 million in 2006-2008 and $3.5 million in 2009, with a return to the $1 million exemption (indexed for inflation) in 2011. No GSTT is in effect for the 2010 tax year.

[27] At the time of enactment this rate was 55%. EGTRRA 2001 reduced the top rates for 2001 through 2009, with a repeal of the GSTT and estate tax in 2010. However, due to the "sunset provision" the GSTT exemption is currently scheduled to return to $1 million in 2011, as indexed for inflation.

[28] The GSTT would be triggered since the interest of the first generation below the transferor would end and result in a transfer to the second generation below the transferor.

[29] The Exempt Trust would be funded with the then available GSTT exemption divided by the number of children for whom the trusts are created. The Non-exempt Trust would be funded with the balance of the child's share.

children without the imposition of the GSTT. The Non-exempt Trust would have a 100% inclusion ratio, and absent the additional planning discussed below, trigger GSTT upon the death of the child.

Since the enactment of the current GSTT in 1986, this author has always maintained that no GSTT should ever be paid. Nothing could be worse than paying the top marginal estate tax rate without the benefit of any other exemption, exclusion or credit. One way to avoid payment of GSTT in the above example would be to provide for a contingent general power of appointment to be granted to a child if he or she dies before full distribution of their Non-exempt Trust <u>and</u> is survived by issue.[30] This contingent general power of appointment would cause inclusion of the Non-exempt Trust assets in the child's estate and eliminate the applicability of the GSTT. Two benefits are created here. First, the child's estate could claim his or her applicable exclusion credit/unified credit, which would shelter no less than $1 million of assets (up to $3.5 million in 2009) in the trust. Further, should the assets of the trust exceed the amount sheltered by the credit, the estate would utilize lower marginal estate tax rates in paying the estate tax rather than having to pay GSTT at the highest marginal rate.

For a more detailed explanation of the GSTT, please see Guardian Sentinel Vol.3, no. (Spring 2002).

<u>Irrevocable Life Insurance Trust</u>. This is an Inter Vivos Trust used to hold life insurance, generally on the life of the Grantor and/or the Grantor's spouse. The purpose of this trust is to have third party ownership of the life insurance to keep the death benefit of the life insurance outside the estates of both the Grantor and the Grantor's spouse. The Grantor, makes the trust irrevocable when it is created and does not reserve any power to amend, alter or terminate the trust or any of its terms. In order to be successful in keeping the assets of the trust out of his or her estate, the Grantor should not retain any interest in the trust that would cause inclusion of the assets in his or her estate.[31]

The trust may provide benefits to any beneficiary the Grantor chooses Trust beneficiaries may include his spouse, children, grandchildren (but be mindful of the GSTT), and other relatives or friends. The trust terms generally define interests of the beneficiaries on the whether the Grantor is alive or deceased. For example, trust that during the Grantor's life the Trustee has the power to distribute income and/or principal to the Grantor's spouse. But upon the Grantor's death the income and/or principal can be distributed to the Grantor's spouse and issue in the Trustee's discretion. This distinction is important since the trust will be worth much more following the Grantor's death if it holds life insurance on the Grantor. As stated earlier, the use of an Irrevocable Trust allows the insurance proceeds to be excluded from the Grantor's estate. If the trust is drafted properly, the assets remaining in trust will also not be included in the surviving spouse's estate, allowing more assets to pass to their children undiminished by estate taxes. The actual terms of the trust will vary from client to client and may incorporate many of the provisions previously addressed in this article.

The ILIT created by the Grantor will be funded by gifts made to the trust by the Grantor. The Trustee will apply for and purchase a life insurance policy, generally on the Grantor's life, with these funds and will pay future premiums with the future gifts

[30] If the trust assets were to pass to a beneficiary who was not a generation below the child (i.e., a sibling), there would be no taxable termination and thus no GSTT would be payable. Therefore, the contingent general power of appointment would not be triggered and the trust assets would pass estate and GSTT tax free to that beneficiary.

[31] For example, a retained income interest (IRC § 2036(a)(1)) or the power to affect beneficial enjoyment (IRC §2036(a)(2)).

made to the trust. After the Grantor's death, the Trustee collects the death benefit and invests it for the benefit of the beneficiaries, distributing income and principal according to the terms of the trust. Generally, the spouse is the primary beneficiary, although the children may be permissible income and/or principal beneficiaries while the surviving spouse is alive. Upon the death of the surviving spouse, the Trustee may either distribute the remaining assets to the children or hold them in further trust for the benefit of the children, again depending on the terms of the trust.
The trust may also employ specific language authorizing the beneficiaries to request distributions from the trust when transfers are made to the trust by the Grantor. These powers are referred to as Crummey powers[32] which are designed to give beneficiaries a present interest in the trust assets so gifts to the trust qualify for the gift tax annual exclusion, (currently $11,000 per donee from each donor). Absent these Crummey powers transfers to a trust do not qualify for the gift tax annual exclusion
since they are future interests.[33] These powers coupled with proper allocation of GSTT exemption (allowing for transfers to future generations) and the avoidance of estate taxes in both the Grantor's and Grantor's spouse's estate make the ILIT a powerful estate planning tool.

GRITS, GRATS & GRUTS. These trusts are referred to as grantor retained trusts. In these trusts the Grantor retains either an income interest (GRIT), an annuity interest (GRAT) or an unitrust interest (GRUT) in the trust. The purpose of these trusts is to allow the grantor to retain an interest in the property transferred to the trust so that the amount deemed to be a gift to the remainderman is reduced by the retained interest. The potential downside to this type of transfer is that if the Grantor does not outlive the term of his or her interest the trust assets are includible in his or her gross estate at their fair market value.

A GRIT, or Grantor Retained Income Trust, provides that the income of the trust is payable to the Grantor for the term of years selected. After the term expires, the assets of the trust pass to the remainderman, either outright or in further trust. This was a popular estate planning technique until the 1980's, when Congress limited its benefits to non-family beneficiaries and created the Grantor Retained Annuity Trust (GRAT) and Grantor Retained Unitrust (GRUT). This was accomplished by valuing the interest retained by the Grantor at zero unless the transfer was to someone who was not a member of the family of the transferor, involved made only the residence of the transferor (discussed later in this article) or qualified as an annuity or unitrust interest.[34] A member of the transferor's family is defined as the transferor's spouse, ancestor, lineal descendant, an ancestor or lineal descendant of the transferor's spouse, a sibling and the spouse of any of the foregoing.[35] This significantly limits the use of a GRIT in most estate planning situations involving family members. The only family exception seems to be transfers to nieces and nephews or more distant relatives. Therefore, the use of GRATS and GRUTS is much more prevalent in estate planning today.

[32] Crummey v. Commissioner, 22 A.F.T.R. 2d 6023, 397 F.2d 82, 68-2 U.S.T.C. ¶12541, (9th Cir 1968), *rev'g* TC Memo 1966-144 , T.C.M. (P-H) ¶66144, 25 T.C.M. (CCH) 772 (1966).

[33] Although Crummey powers are usually tied to the gift tax annual exclusion, potential lapses of these powers in excess of the $5,000/5% de minimis amounts under IRC § 2514(e) may cause additional tax complications. In order to fully utilize the annual exclusion amounts available to the beneficiaries, the lapse of the Crummey power is usually limited to these § 2514(e) amounts with the balance of the Crummey power continuing. These are referred to as "hanging" powers since they remain in effect until such time as they may lapse under the § 2514(e) limits.

[34] IRC §2702(b).

[35] Treas. Reg. § 25.2702-1(a).

A GRAT requires that an annual annuity amount be paid to the Grantor for the term of years selected. The value of the annuity amount is generally expressed as a percentage of trust assets, which must be no less than 5% nor more than 50%. It is the value of this annuity stream that may be subtracted from the gross value of the property transferred to the trust to arrive at the value of the gift, which is the remainder interest. For example, if the Grantor wishes to transfer property valued at $1 million to a GRAT and retains an annuity payment of $60,000 for a term of 5 years at an AFR rate of 4.2%, the retained annuity interest will be valued at $264,614. This may be subtracted from the gross value of the property transferred to arrive at the value of the gift transferred to the remainderman, which would be $735,386. If the GRAT receives a return on its investments in excess of the annuity amounts paid to the Grantor, investment returns these also inure to the benefit of the remainderman. If the income is less than the amount required to be paid out, principal is paid out to make up the difference. In either case, the Grantor receives the annuity amount. If the Grantor survives the five-year term, the assets of the trust (the investments at their then value plus any income earned in excess of the payments made to the Grantor during the term) pass to the remainderman, either outright or in further trust. If the value of the trust assets is now $1.3 million because of the appreciation of the principal of the trust plus income earned in excess % the annuity payments made, this passes to the remainderman free of tax.[36] The benefit of this technique to the Grantor is that he or she has transferred $1.3 million of assets to the beneficiaries while only having been charged with gifting $735,386 at the time the GRAT was created. Of course, if the Grantor dies before the term is completed, the assets of the trust are included in his or her gross estate at their current value.

The GRUT works the same way except that the annual payment is not an annuity amount, but instead is based upon a percentage of the value of the assets from year to year, which is called a unitrust interest. Therefore, the value of the annual payments may increase or decrease based on the value of the assets of the trust. Another benefit of the GRUT is that the Grantor may make additional transfers to the GRUT after its initial creation, which is not allowed when using a GRAT.

The possible downside of creating a single GRAT with the Grantor does not survive the term selected may be overcome by creating a series of GRATs. For example, if the Grantor created a single GRAT for a term of ten years and died in the ninth month of the ninth year, the entire trust corpus would be included in his or her estate.[37] So close, but no cigar. A better alternative would be to create several GRATs with different terms of years. For instance, separate GRATs for three years, six years and ten years could be created and funded with an amount of assets that would result in the same taxable gifts as one GRAT for a term of ten years. The difference here is that upon the Grantor surviving for 3 years, the assets of the three-year GRAT would be outside of his estate. Same for the six year GRAT. And if the Grantor dies in the ninth month of the ninth year, all is not lost since the assets of the three and six year GRATs escape inclusion in the estate. The only GRAT included in the Grantor's estate would be the ten-year GRAT. This is much better than losing the entire amount in one ten year GRAT.

For a more detailed explanation of GRITs, GRATs and GRUTS, please see Guardian Sentinel Vol.4 no. (Autumn 2002).

[36] This assumes that all income taxes of the Trust were paid by the Grantor during the GRAT's term, which should be true since the income is taxed to the Grantor under IRC § 677.

[37] IRC § 2036(a)(1).

QPRTs and PRTs. These trusts, a Qualified Personal Resident Trust (QPRT) and a Personal Residence Trust (PRT), are specifically designed to hold the residence of the Grantor. The concept is the same as a GRIT, except that instead of providing an income payment to the Grantor, the Grantor simply retains the right to reside in the residence for a term of years with the remainder passing to the remainder beneficiaries at that time. These trusts are an exception to the zero valuation rule for retained interests discussed above and are utilized in the same manner as the GRAT and GRUT discussed above except that the retained interest is not an annuity or unitrust interest, but rather the right to remain in the residence for the term of years specified.

Similar to the GRAT and GRUT discussed above, the QPRT and PRT are designed to leverage the gift of the residence to the trust by subtracting the value of the retained interest (the right to live there) from the gross value of the residence transferred. If the Grantor survives the term selected, the residence passes to the remainderman, outright or in further trust. Any appreciation of the residence also passes at that time tax free. For example, if the value of the residence is $1 million and the value of the term interest retained is $400,000, the value of the gift by the Grantor would be $600,000. If the Grantor survives the term selected and the value of the residence has increased to $1.3 million, the remainderman receives the $1.3 million residence while the Grantor has made a gift of only $600,000, a most beneficial result.

The PRT is very limited in its use since it cannot hold any property or assets other than a residence. Accordingly, the QPRT is the trust most commonly used to benefit the Grantor. A QPRT allows the trust to hold cash for payment of expenses and improvements to the residence as well as insurance on the property. Should such cash produce investment income, the investment income must be paid to the Grantor. The trust may also sell the existing residence and purchase a new residence. Lastly, should the QPRT sell the residence and not purchase a new residence within two years of the sale, the Trustee may convert the QPRT to a GRAT or distribute the proceeds to the Grantor. Should this occur, the better choice is to convert to a GRAT since the primary purpose was to avoid having the gross value of the residence (plus appreciation) included in the Grantor's gross estate.

Should the Grantor desire to continue to live in the residence after the term selected expires, it is imperative that the Grantor pay fair market value rent to the trust or remainder beneficiaries since the Grantor no longer has the right to live in the residence. The failure of the Grantor to pay this fair market value rent would cause inclusion of the residence's fair market value at the time of the Grantor's death to be included in his or her estate since the Grantor would have retained an interest (the right to live in the house either rent free or at a less than market value rent) in the property transferred to the trust.[38]

CRATS and CRUTS. These trusts are referred to as charitable remainder trusts (CRTs). They are trusts in which the Grantor retains either an annuity interest (CRAT) or an unitrust interest (CRUT) in the trust of at least 5%. The interest retained by the Grantor may either be for a term of years (not less than 5 nor more than 20) or based on one or more lives. Upon the expiration of the Grantor's interest, the property in the trust passes to a qualified charity. The purpose of these trusts is to allow the Grantor to retain an interest in the property transferred to the trust with the remainder interest passing to a qualified charity at the conclusion of the term selected or upon death if a life term is

[38] IRC § 2036(a)(1).

selected. If the Grantor dies while still having an interest in the trust, the trust assets would be includible in his or her estate but will be afforded a charitable deduction since those assets would pass to a qualified charity.

CRATS and CRUTS are generally used by Grantors who desire to retain a qualified interest in the property transferred and who are charitably inclined. However, there are also tax advantages in creating CRTs with property that has a low basis and high current value. Since the principal will ultimately pass to a qualified charity, if the trust sells the asset initially contributed to the trust, any capital gain is attributable to the charity, which is a non-taxable entity. Therefore, the sale of the assets by the trust would not trigger a payment of a capital gains tax at the time of the sale and the entire purchase price would be available to the trustee to invest. Since more assets will produce more income, these could provide a larger income stream for a CRT since the payout is based on the value of the trust's assets. The annuity interest or unitrust interest paid to the grantor or other beneficiary will, however, be treated as ordinary income or capital gain to the extent the trust has income on capital gain to distribute.

For example, if the Grantor has an asset worth $1 million with a basis of $50,000, he or she could elect to sell it and incur a capital gains tax[39] of $142,500, leaving $837,500 to invest. With the use of a CRT, the full $1 million of sales proceeds would be available. Using a 6% payout, this would result in a payment of $60,000 rather than
$50,250.

One additional requirement of CRTs is that the value of the remainder interest passing to the charity must be at least 10% of the value of the assets contributed to the trust using the IRS § 7520 AFR rates which are published monthly. Any trust not meeting this requirement will fail as a CRT. The value of the remainder interest that is computed at the creation of the trust to satisfy this requirement qualifies as an income tax charitable deduction by the Grantor in the year the trust is created, subject to the AGI limitations. To the extent the deduction is not used, it may be carried forward for 5 years, again subject to the AGI limitations.

<u>CLATS and CLUTS</u>. These trusts are the reverse of CRATS and CRUTS discussed above. They are designed to have the annuity or unitrust interest paid to a qualified charity for a term of years with the remainder interest passing to non-charitable beneficiaries, such as the Grantor's children. The are referred to as Charitable Lead Annuity Trusts (CLATs) or Charitable Lead Unitrusts (CLUTs).

These trusts are designed to provide a qualified interest to the charity, the value of which is deducted from the value of the property transferred to the trust to arrive at the value transferred to the remainderman. It is this remainder interest value that is the value of the gift to the Grantor's children at the time the trust is created. This is simply a leverage technique to gift assets to the children at a reduced transfer time cost while providing a stream of payments to the Grantor's preferred charity. Unlike GRATs or GRUTS, where the Grantor must survive the term of years selected to escape estate inclusion, these types of trust are out of the Grantor's estate immediately and the Grantor has made a completed gift upon creation of the trust.

For example, if the Grantor created a CLAT with $1 million in assets and provided for $70,000 annuity payments to be made to a qualified charity for a term of 7 years, the value of the charitable interest would be $417,053. Therefore, the gift to the remainderman of the trust (Grantor's

[39] Based on a Federal 15% maximum capital gains rate. State and local taxes could very well increase the total taxes paid.

children) would be $582,947. If the value of trust assets at the end of the seven year term is $1.4 million, this would be passed to the Grantor's children although the Grantor was only charged with a $582,947 taxable gift. The key here is any increase in the value of trust assets over the term inures to the benefit of the Grantor's children with no tax assessed on this growth.

A CLUT works in a similar manner except that instead of an annuity interest being paid, an unitrust interest is paid based on the value of the trust year to year. This would allow the charity to receive annual payments which may increase or decrease based on the value of the trust assets.

Supplemental Needs Trust. This is a trust created for a disabled beneficiary and is sometimes referred to as a special needs trust.[40] The purpose of this trust is to provide benefits to the disabled person to supplement government payments such as Medicaid or Social Security without jeopardizing eligibility for such government programs. It is generally created for the disabled beneficiary by a parent or grandparent to provide for additional benefits not available from government payments. An individual may also create a supplemental needs trust for his or her own benefit (called a self-settled trust), but stringent requirements must be met in order not to jeopardize or reduce the benefits available from the government.

2503(c) or Minors Trust. This trust allows transfers to it for the benefit of the minor to be treated as gifts of a present interest qualifying for the gift tax annual exclusion.[41] In order to obtain this favorable tax treatment, the trust must provide that 1) principal and income of the trust may be expended for the benefit of the minor at any time before the age of 21; 2) the principal and income will pass to the beneficiary upon attaining the age of 21; and 3) should the minor die before the age of 21, the principal and income of the trust shall be payable to the minor's estate or the minor shall have a general power of appointment over the trust.[42] It may be possible for the trust to continue after the beneficiary attains age 21 if the trust terms so provide and the beneficiary does not withdraw the assets of the trust even though he or she has the right to do so.

Spousal Limited Access Trust (SLAT). The SLAT is a special trust that allows the Grantor's spouse access to the trust assets in the discretion of the trustee while keeping the trust assets out of both the Grantor's and the Grantor's spouse's estates. Generally, the Grantor creates the trust and names the spouse as a permissible beneficiary, both during the Grantor's lifetime and after the Grantor's death. The trustee selected is usually a "friendly" trustee, such as the Grantor's or Grantor's spouse's sibling. The Grantor funds the trust with an initial transfer of assets such as cash or investment assets and may make additional contributions to the trust. Generally, contributions to the trust would be subject to Crummey powers with hanging provisions exercisable by the Grantor's children, which would allow the gifts to be treated as present interests, qualify the contributions for the gift tax annual exclusion. The Grantor's spouse is not given a Crummey power.[43] For example, if the couple had three children, the Grantor could gift $66,000 to the trust (by electing gift-splitting as discussed below) and could utilize both spouses' gift tax annual exclusions for the three children. This would allow the couple to keep their respective applicable exclusion credits/unified credits intact.

[40] See Guardian Pubs. 1823 and 1824.

[41] IRC § 2503(b). The current gift tax annual exclusion is $11,000 per donor per donee.

[42] IRC § 2503(c).

[43] It is this author's belief the lapse of such a Crummey power may be treated as a gift (although a de minimis one under IRC § 2514) for estate tax purposes which could trigger estate inclusion under IRC § 2036(a)(1).

An important trust term and the key to the operation of this trust is that the Grantor's spouse is prohibited from making any gifts to the trust. Any contribution made to a trust of which the spouse is a beneficiary could be construed as a transfer with a retained interest and could cause inclusion of trust assets in the surviving spouses estate,[44] a result good planning tries to avoid. However, the Grantor's spouse could elect to split the gifts made by her husband, the Grantor. That is, the Grantor's spouse can elect to treat one-half of the gifts made by her husband as made by her.[45] The election to split gifts is for gift tax purposes only and the consent to split the gift does not make the Grantor's spouse the transferor for estate tax purposes.[46] Therefore, although the Grantor's spouse's annual exclusions may be utilized for the transfers made to the trust of which she is a beneficiary, those transfers are not subject to potential estate inclusion as transfers with a retained interest under IRC § 2036 since they are not considered to be transfers for estate tax purposes. The trust assets may be distributed to the spouse under the terms of the trust and could then be made available to the Grantor under the unlimited gift tax marital deduction,[47] assuming the Grantor is a U.S. citizen.

This type of trust is particularly useful in planning with life insurance, whether the poly is a single life policy or a second to die policy. The cash value of the policies may be made available to the beneficiary spouse by the trustee under the terms of the trust and the Grantor spouse may then enjoy these benefits by interspousal transfers.[48] More importantly, the death benefit of the policy should remain outside out of the Grantor's and Grantor's spouse's estates. This allows the Grantor and Grantor's spouse to enjoy the use of the assets in the trust and still keep the death benefit out of both estates. However, one consideration when using a second to die policy in this scenario is to provide for a mechanism to pay the future premiums if the Grantor predeceases the Grantor's spouse. The Grantor's spouse cannot provide the premiums, since he or she is prohibited by the terms of the trust from making gifts to the trust. Payment of premiums may be accomplished by having a single life policy on the Grantor owned by the trust, by funding the trust with other assets to provide funds for the additional premiums that would be due following the Grantor's death or by designing the policy to "premium off-set" so dividends are sufficient to pay any future premiums. Some SLATs may even contain provisions for distribution of the trust assets to the spouse should the estate tax be repealed, but this may prove costly if the estate tax is reinstituted at a later date. A properly drafted SLAT should provide the flexibility to address these issues.

<u>Grantor Trusts</u>. A grantor trust is a trust that is ignored for income tax purposes with all income taxes due on the trust income the responsibility of the Grantor on his individual income tax return. In order to receive this tax treatment, the trust must qualify for grantor trust status under IRC §§671(679). These IRC sections were originally enacted to prevent taxpayers from shifting income from the high income tax bracket of the Grantor to lower income tax brackets of the trust or that beneficiaries. These types of trusts are now used in estate planning to further leverage gifts made to a trust that produce income in the trust. For example, if a trust is deemed a grantor trust and earns $100,000 of interest income on its assets, the $100,000 of interest income is taxed to the Grantor who has the responsibility to pay the income tax. The $100,000 of income remains in the trust, undiminished by the payment of income tax,

[44] IRC § 2036(a)(1).
[45] IRC § 2513.
[46] Rev. Rul. 54-246, 1954-1 CB 179.
[47] IRC § 2523.
[48] It should be noted that the Grantor's "access" to the trust assets may be only as good as his marriage.

available for further investment or distribution to the beneficiaries. If the trust was not a grantor trust and had to pay taxes on this income at say a 40% rate that would leave only $60,000 in the trust for investment or distribution.

In estate planning, the transfer to a grantor trust will be complete transfer for gift and estate tax purposes but the payment of income taxes by the Grantor will not be deemed an additional gift to the trust. Therefore, to properly plan for estate and gift tax purposes, the mechanism chosen to trigger grantor trust status must be one that does not cause potential estate inclusion for estate tax purposes. For instance, the Grantor retaining a right to income of the trust would qualify the trust as a grantor trust.[49] However, the trust would also be includible in his gross estate because this would be a transfer with a retained interest.[50] Provisions that are generally used to qualify trusts as grantor trusts without the negative result of estate inclusion include powers to: distribute income to the Grantor's spouse,[51] use income for payment of life insurance premiums on the life of the Grantor or Grantor's spouse,[52] allow the Grantor to borrow the trust income or corpus without adequate security or without adequate interest,[53] or allow the Grantor to reacquire the trust corpus by substituting other property of equivalent value.[54] However, it is this author's opinion that the power to substitute property of equivalent value may cause inclusion of the trust corpus if the trust corpus consists of life insurance on the Grantor's life since this may be construed as an incident of ownership in any life insurance policy on the grantor's life.[55]

Another benefit of the grantor trust is that transactions between the Grantor and the grantor trust are ignored for income tax purposes since they are one and the same taxpayer. This would allow for a sale of assets by the Grantor to the trust (at fair market value) without the Grantor recognizing a capital gain on the "sale." This may prove to be beneficial to the Grantor's estate planning since any appreciation of the sold property would inure to the benefit of the trust beneficiaries. The amounts included in the Grantor's estate would be whatever the "sales" proceeds were, whether cash, a note or a combination thereof. This would effectively "freeze" the value of the asset in the Grantor's estate. This technique is sometimes referred to as a "Sale to an Intentionally Defective Grantor Trust (IDGT)." It should be pointed out that there may be a capital gain tax due when the grantor trust loses its grantor trust status, whether at the death of the Grantor or by some other means. Further intricacies and uses of grantor trusts are beyond the scope of this article and will not be covered here.

Family Incentive Trusts. These trusts are generally designed to motivate children or grandchildren who are beneficiaries of the trust to be productive in establishing careers or contributing to the community rather than depending solely on income and principal distributions from the trust. The Grantors of these trusts may be concerned that the beneficiaries will just sit back and receive trust distributions rather than improving themselves through obtaining an education, establishing a career or contributing to the community.

To encourage the behavior desired by the Grantor, distributions from the trust may be tied to attainment of goals outlined by the Grantor. For example, set amounts of principal distributions may be made available when the beneficiary receives a college degree, a graduate degree, or a professional license,

[49] IRC § 677(a)(1).
[50] IRC § 2036(a)(1).
[51] IRC § 677(a)(1).
[52] IRC § 677(a)(3).
[53] IRC § 675(2).
[54] IRC § 675(4)(c).
[55] See generally Reg. 20.2042-1(c)(2)

when he or she maintains a 3.0 average, etc. Other desired behavior such as being a stay - at - home parent or doing charitable work in the community may also be rewarded. The idea behind this type of trust is to encourage the development of the beneficiary by providing an incentive to pursue a full and rewarding life rather than encouraging the beneficiary to be a "trust fund baby" dependent solely on the trust for support.

Family incentive trusts can also provide principal distributions to match the beneficiary's earned income, encouraging the beneficiary to be gainfully employed. These types of trusts can also be used to discourage behavior such as the use of drugs or the excessive use of alcohol by requiring medical tests prior to discretionary distributions from the trust. Although these types of trusts appear to be attractive to the Grantor who wishes to encourage desired behavior, administration of these trusts can be difficult where beneficiaries are with non-cooperative, and may subject the Trustee to litigation as to whether the behavior required to trigger distributions is valid or contrary to public policy. This could be one reason the trust's acronym is FIT.

Conclusion

There seems to be a type of trust to cover every almost possible situation. However, estate planning requires ascertaining the goals and objectives of the clients, and more often than not, trust planning almost always enters the planning process. The purpose of this article is to generally discuss the uses of different types of trusts and their accompanying benefits, which may serve a starting point in the estate planning process. Of course, each client's situation will be unique and it is up to the estate planning attorney to ascertain which trusts may best serve the client's needs