TRUSTS: AN OVERVIEW

I am an estate planning attorney. I recommend using trusts to accomplish various objectives of my clients. I have become increasingly frustrated with the way trusts are administered by the trustee. I have struggled with various methods to have these trusts actually operate the way the person who created them wanted them to. Tax laws and an increasingly litigious and complex society have thwarted the best of intentions. In this booklet, I focus on trusts which are created by a parent for the benefit of his or her children. It is designed to reflect on how these trusts currently operate, what the intent of the parent was in creating them, review relevant literature and research in other areas which provides guidance on the impact of these provisions and propose an alternative structure to be used during the parents' lifetimes and upon their deaths to better carry out the parents' intentions. My objective is to design a trust structure which enables the parent to leave the type of legacy that he or she truly desires. The primary focus will be on the structure and administration of trusts for the benefit of a family's children while these children are between the ages of 20 and 40. For purposes of illustration and to save you from more verbiage, I frequently use the scenario of the husband predeceasing the wife. However, the same treatment occurs if the wife predeceases the husband.

Since trusts and their administration are not generally a part of our lives, many people are not sure what a trust is, how much latitude we have in structuring them and how they function. The purpose of this chapter introduction is to describe a trust and its various uses in estate planning. This introduction provides an overview of trusts commonly used in estte planning. Several of the trusts identified in this introduction are described in more detail in the sections of this chapter.

What is a Trust? Who are the Players?

A trust is a form of contract. The person who creates the trust, the ***grantor*** (also sometimes referred to as "settlor" and "trustor"), requests another person, the ***trustee***, to hold property for the benefit of a third person, the ***beneficiary***. A trust is usually set out in a ***Will or trust agreement*** and is not restricted to any particular terms or language. In fact, a provision in Mary's Will which states, "I leave $50,000 to my brother, John, to use to educate my niece, Nancy" creates a trust upon Mary's death where Mary is the grantor, John is the trustee and Nancy is the beneficiary. If the Will or other document which describes the trust relationship leaves out the trustee's powers, as in Mary's Will, or other convenient provisions, then Texas law as found in the Texas Property Code provides those powers or provisions. For example, if the Will or other document does not provide for an alternate person to serve as trustee if John cannot, then the Texas Property Code includes provisions for the appointment of a successor trustee. If terms are left out of

the trust agreement or if the terms as set out in the trust agreement are ambiguous, then the beneficiaries may apply to a state court to determine what the grantor intended. Although trust agreements can be as simple as one statement, most trust agreements include all of the provisions necessary to manage the trust.

Parts of a Trust

A trust generally:

- **Names the grantor**. The grantor is the person who creates the trust. Mary, who included the above provision in her Will leaving $50,000 to her brother, John, to use to educate her niece, Nancy, is the grantor.

- **Names the trustee**. The trustee is the person who will hold the property put into the trust, manage the property and distribute income and principal as set forth in the trust. In the above example, John is the trustee.

- **Identifies the beneficiaries**. The beneficiaries are the persons for whose benefit the trust assets are held. The trust can benefit only one person, such as “my niece, Nancy” or can benefit a group of people, such as “all of my children” or “all of my descendants.”

- **Must be funded**. The grantor must contribute some property and at least $1, to the trust in order for the trust to exist.

- **Provides for distributions**. The trust agreement provides when and for what reason the trustee will distribute the property to the beneficiaries. For example, the trust can provide that the trustee will hold the property and reinvest the property and the income from the property, making no distributions until the beneficiary is a certain age, e.g. 25, and then the trust terminates and all of the property is distributed to the beneficiary. More commonly, the trust agreement will provide that some distributions can be made prior to the termination of the trust. For example, the trust can provide that all income earned on the assets in the trust will be distributed to the beneficiary. The trust may provide that the trustee will distribute the income only if the beneficiary needs it for his education or for his health needs. The trust can provide that income is distributed but that principal is not distributed. The trust can provide that income and principal may be distributed if the beneficiary needs it. The distribution provisions are the ones that outline the beneficiary’s rights in the trust assets. These trust agreement provisions are the most important provisions of the agreement and reflect the desires of the grantor regarding how the trust property shall flow to the beneficiary.

Generally, income generated by trust property is ordinary income for federal tax purposes and generally includes interest, dividends, and rents. There are actually some distinctions between

trust accounting income and taxable income, but this is a helpful shorthand reference. Principal is the trust property transferred to the trust and all appreciation in that property. Generally, capital gains are considered part of principal.

- **Identifies the trustee's powers**. The trust usually includes a list of the powers that the trustee has relating to managing the trust. Generally these powers are in addition to any powers granted to trustees under state law. For example, the grantor may want to give the trustee the power to loan money (a trust asset) to the beneficiary.

- **Includes a spendthrift clause**. Frequently, trusts include a spendthrift clause which provides that the beneficiary cannot pledge the assets of the trust as collateral on a loan nor can he assign his right to receive income from the trust. This provision protects the assets in the trust from the claims of creditors of the beneficiary.

A trust can be created during someone's lifetime or created upon his death. If the trust is created during the grantor's lifetime, the trust is an ***inter vivos trust***. An inter vivos trust is memorialized in a written trust agreement. One trust agreement can create several trusts. For example, the trust may provide that each time the grantor puts money in the trust, the trustee is to divide the money into three equal parts, one for each of the three children of the grantor. If the trust is to be created upon the grantor's death, the trust is a ***testamentary trust***. A testamentary trust is generally included as part of the provisions of a person's Will. If the person created a trust during his lifetime, such as a Revocable Living Trust, to go into effect upon his death, then the trust to go into effect upon death would be included as part of the provisions in the Revocable Living Trust.

Trusts can also be revocable and irrevocable. A ***revocable trust*** is a trust which the grantor (the person who creates the trust) can amend, cancel or revoke at any time. An ***irrevocable trust*** cannot be cancelled, revoked or even amended after it is made. Since testamentary trusts are not created until the grantor has died, they are irrevocable upon the grantor's death. Prior to the grantor's death, they have not gone into effect, so the grantor could change his Will or Revocable Living Trust to change the provisions of a testamentary trust or to eliminate it completely. In the example above, the grantor could change his Will to provide "I leave $50,000 to John to hold for the benefit of my niece, Nancy, to be held until she is 25 years old." Under the change, John cannot use the money to pay for Nancy's education, and he must turn over all the trust assets to Nancy when she reaches 25 years of age.

Trusts are used in estate planning for various purposes, including: to provide tax reduction benefits, to hold property for a person until he or she is mature enough to manage it, to hold property for distribution only for specific purposes, to protect property from the claims of a beneficiary's creditor, to protect property from the claims of an estranged spouse of a beneficiary, to provide for the management of property with distributions for a beneficiary's long term support, and

for any other reason that the grantor desires. The trust agreement drafter writes the agreement with the grantor's intentions in mind. Trusts in their simple form are fairly straight forward to write. One aspect of trusts which makes them complicated is the tax laws which frequently makes additional drafting necessary. Some federal tax code sections specifically prescribe the terms of a trust agreement in order to get a certain tax treatment, so the drafter uses that language in the trust agreement. For example, the inclusion of certain provisions in a trust agreement will cause the trust property to be included in the grantor's taxable estate, generally a very undesirable result; therefore, the drafter will not write that language in the trust agreement. Other provisions will cause the property to be included in the beneficiary's taxable estate. Sometimes being taxed in the beneficiary's estate is desirable and sometimes it is not. When it is beneficial, the drafter of the trust agreement will include those provisions. A trust with certain characteristics is usually given a special name or names (" shorthand names") by the drafter to provide a shorthand description of the trust provisions. There is no official use of the names; however, estate planning attorneys, when they use the shorthand names, immediately communicate with each other because by using the shorthand name, they know what provisions are in the trust agreement and recognize how the trust will operate. The names come from several sources: the name may be descriptive of what the trust does; the name may refer to specific provisions in the Internal Revenue Code; or the name may be the name of a court case which litigated the provisions used in that trust. The grantor can design the trust for any beneficiary he wants, any trustee he wants and any distribution provisions he wants; therefore, there are as many different types of trusts as there are individuals creating them. Since trusts can include several different provisions in order to reflect the trust the grantor wants, with each provision having its own shorthand name, trusts are more like casseroles than they are like individual servings of meats and vegetables. Some of the types of trusts (with their shorthand names) commonly used are:

Bypass Trust.

This trust is also called a B-Trust, an Exemption Trust or a Credit Shelter Trust. In a trust agreement, it may be "named" for example, "The Stephens Family Trust" and never refers to the shorthand name at all. The Bypass trust is a testamentary trust and is used when a husband and wife have property valued in excess of the amount which is exempt from estate tax. In 2001, $1 million is exempt from tax. The exemption is scheduled to increase to $3.5 million by 2009 and be dropped back to $1 million in 2011 after a one year repeal of estate taxes in 2010. Let's assume we have a couple with $2 million in property owned by the spouses equally, so that each owns $1 million. If each spouse left his property to his children, then neither spouse would owe a tax. However, the deceased spouse generally wants the surviving spouse to have his/her $1 million available for the survivor's support. If either the husband or wife left all of their property to the survivor *outright*, the survivor would have a $2 million estate and would owe an estate tax of $435,000 if he/she died in 2002. Since the exemption increases to

$2 million in 2006 there would be no tax in 2006 *if* the property did not appreciate. By leaving the deceased spouse's $1 million in a trust for the benefit of the survivor, the survivor can have the use of the full $2 million, but avoid having the deceased spouse's $1 million included in the survivor's estate. The trust is called a "**Bypass Trust**" since the property held in the trust bypasses taxation in the surviving spouse's estate.

The trust agreement must be structured so that the $1 million of assets is not included in the survivor's estate; therefore, the trust agreement must include some restrictive provisions. For example, the survivor cannot be given such broad powers over the trust and its assets that the IRS would treat the trust property as the property actually owned by the survivor. The trust agreement can provide that the spouse is the only beneficiary or may include the children also as beneficiaries. The trust can provide that the income must be distributed to the spouse or that only the amount of income needed for the spouse's support is to be distributed to the spouse. The trust can provide that the principal may be distributed to the spouse if the spouse needs it or can prohibit any distributions of principal. Although this type of trust is designed to save estate taxes on the death of the surviving spouse, the trust also will ensure that the deceased spouse's property actually passes to the deceased spouse's children on the survivor's death. This benefit has become increasingly important as the number of multiple marriages increases, so that, in many cases, the children of one spouse are not also the children of the other spouse.

QTIP TRUST: Qualified Terminable Interest Property Trust

The Qualified Terminable Interest Property Trust is known as a **QTIP** trust. The name is the name the Internal Revenue Code gives this type of trust. The trust is a testamentary trust (the trust can be created during a person's lifetime but rarely is) for the <u>sole benefit</u> of the surviving spouse. Prior to 1981, a person could leave up to half of his separate property to his spouse, and the gift to the spouse would be deductible in determining the estate tax owed. The gift to the spouse had to be either outright or in a trust which allowed the surviving spouse to give the property to anyone he or she wanted; the trust interest could not terminate. In 1981, the law was changed to allow a person to give all of his property to his spouse without tax. In order to allow the deceased spouse to give the surviving spouse the use of his estate (usually that amount over the Bypass amount in 2002 of $1 million) during her lifetime *but still control* to whom the property passed on the surviving spouse's death, a new trust was created. The main goal of the QTIP is to allow a person to leave property in trust for his or her spouse's benefit and allow that person to designate those persons who will ultimately receive the property upon the surviving spouse's death. Upon the death of the surviving spouse, the property is included in the surviving spouse's estate and is subject to estate tax.

The QTIP trust must provide that all income is paid to the surviving spouse. The trust can provide for distributions of principal if needed by the spouse or can prohibit distributions of principal.

2503(c) Trust - Trust for Minors

The 2503(c) Trust is named after a section of the Internal Revenue Code. Section 2503 provides for the exclusion from gift tax of gifts up to $11,000 per year. Any person can give up to $11,000 to as many different people as he would like. If a person wanted to give $11,000 to each of 10 people, he could give the entire $110,000 without tax. This is the famous "annual exclusion" amount to which estate planning attorneys alert you. Giving annual exclusion gifts every year is usually the first technique suggested for reducing the value of one's estate. To qualify for the $11,000, exclusion the recipient/donee must have the right to use the property today. This right is referred to as the "present interest" requirement. However, what if the recipient is a 5 year old child? The child will not (and we would not want them to) have the right to use the money today; therefore, we would prefer for the child to receive the gift in trust so that a trustee can manage the trust property. However, a gift to a trust is a gift of a future interest and not a present interest and would not qualify for the annual exclusion from gift tax. Recognizing that this situation is a special situation, the Internal Revenue Code provides that a gift to a minor child (anyone under age 21) in trust qualifies for the $11,000 annual exclusion from gift tax if the trust is structured as set forth in Section 2503(c) of the Internal Revenue Code.

The trust can have only one beneficiary, the minor child. The trust assets, both income and principal, must be available for distribution to the child during the term of the trust for the child's benefit. If the child dies prior to reaching age 21, the property must be included in the child's taxable estate. These trusts are inter vivos trusts since they are designed to receive gifts during someone's lifetime. The terms are very restrictive and cannot vary from the provisions of Section 2503(c) of the Internal Revenue Code.

Crummey Trust

The Crummey Trust is named after a taxpayer who created a trust with particular provisions to make gifts to the trust qualify as "present interest" gifts and therefore qualify for the annual exclusion from gift tax. The taxpayer's name was "Mr. Crummey." It is not a description of the type of person he was or the type of trust document. The trust is designed to qualify for the $11,000 annual exclusion from gift tax. As described in the above paragraph, since the property is not given to the beneficiary outright but in trust, the beneficiary would not have a present right to use the money; hence, the gift would not qualify for the $11,000 annual exclusion. In order to give the beneficiary a present right to the money, qualify for the $11,000 annual exclusion but still use a trust, the trust gives the beneficiary, after notification by the trustee, the right to withdraw the $11,000 gift from the trust for a period of 30 days from the date the gift was contributed to the trust (gift was made). If the beneficiary does not notify the trustee that he/she wants to withdraw the money from the trust, the beneficiary's right lapses and the money remains in the trust to be distributed according to the terms of the trust. Mr. Crummey created a trust using this annual withdrawal right for his small children, e.g. ages 1 and 4. The IRS challenged the use of this type of trust with small children. Mr. Crummey won the case and hence a trust with these

provisions has come to be called a Crummey trust.

A Crummey trust is an inter vivos trust since it is designed to receive annual exclusion gifts during the lifetime of the grantor. This type of trust can have any type of terms without restriction. By adding the "Crummey withdrawal power," the trust becomes a Crummey trust. However, two Crummey trusts may have no similarities other than the fact that each trust contains the withdrawal power. For example, one Crummey trust may provide that there is one beneficiary who is currently age 5. The trust could provide that no distributions may be made during the term of the trust. The trust terminates when the beneficiary reaches age 25. Another Crummey trust may have six beneficiaries, two of the grantor's children and four of his grandchildren. Each of the six beneficiaries could have the right to withdraw 1/6 of the contribution, enabling the grantor to give $66,000 to the trust without gift tax. The trust could provide that the income and principal may be distributed to any of the beneficiaries for their health, education, support and maintenance. The trust could provide that the distributions may be unequal. The trust may provide that the trust continues until the last of all of these beneficiaries die. Clearly, these two trusts are very different. Crummey trusts can be as different as the people that create them and the beneficiaries for whom they are created. These trusts are structurally very flexible.

Irrevocable Life Insurance Trust.

An irrevocable life insurance trust is a trust which is designed to own life insurance on the grantor's life. The purpose of the trust is to keep the insurance proceeds out of the grantor's estate for federal estate tax purposes. It would be included in the grantor's estate if the grantor continued to own the life insurance policy. In order to keep the insurance out of the grantor's estate, the grantor cannot be a trustee of the trust and cannot have any other rights in the trust. Usually these trusts have Crummey withdrawal powers in them to cover a gift(s) to the trust of the annual policy premium(s) but are referred to as life insurance trusts, since their primary purpose is to hold the life insurance. One might say he has an ***ILIT*** (an irrevocable life insurance trust), and someone might ask him whether it is a Crummey trust; i.e., does it have Crummey withdrawal powers.

Other than restricting the rights of the grantor, the irrevocable life insurance trust can have a myriad of provisions. One common structure is for the spouse of the grantor and the grantor's children to be beneficiaries of the trust. However, the trust could be designed for the sole benefit of the grantor's children or could be created for the benefit of someone unrelated to the grantor.

Generation Skipping Trust.

A generation skipping trust (***GST*** trust) is any trust which is designed to avoid taxation in the grantor's children's estates and avoid the generation skipping tax (55% - 45% depending on the top estate tax rate) to the extent distributions from the trust are made to the grantor's grandchildren and great-grandchildren. The grantor's children can be beneficiaries of the trust and are entitled to receive distributions during their

lifetimes, but the trust will continue for their entire lifetimes and be distributed to the grandchildren or continue to be held in trust for the grandchildren. A generation skipping trust can also be designed so that the only beneficiaries are grandchildren, great grandchildren and so on. A generation skipping trust may have Crummey withdrawal powers. In fact, the second example above of a Crummey trust benefitting the grantor's two children and four grandchildren is a generation skipping trust. A generation skipping trust may also own life insurance; thus, it could be a Crummey, irrevocable life insurance, generation skipping trust.

The terms of a generation skipping trust may also vary considerably. A child or several children may be beneficiaries or none of the children may be beneficiaries. The distribution provisions may be very restrictive and only provide for distributions for education or may be very broad, allowing distributions for other purposes. The trust may terminate after the children's death or may continue for the grandchildren's lifetimes as well.

QPRT: Qualified Personal Residence Trust.

A Qualified Personal Residence Trust (QPRT) is designed to qualify to own a person's residence under a specific provision of the Internal Revenue Code. Use of the trust enables a person to transfer his house at a reduced gift tax cost to his children or any other person. The Internal Revenue Code includes the name of these trusts in the code section in which they are allowed. The trust may hold only a personal residence and is not structured to receive any other gifts. The trust can continue for any term of years selected by the grantor. During the term of the trust, the grantor has the right to live in the house. At the end of the term, the house passes to the grantor's children or may be held in trust for the benefit of the children (or some other person).

During the primary term of the trust, which can be from 2 to 10 years, but can be shorter or longer, the grantor has virtually no flexibility in the terms of the trust due to the IRS requirements. After the primary term of the trust expires, the grantor can have the trust continue for other beneficiaries and can design this extension trust in a variety of ways.

GRAT: Grantor Retained Annuity Trust

A Grantor Retained Annuity Trust (GRAT) is also designed to qualify for special tax treatment under a provision of the Internal Revenue Code. The trust must pay a fixed amount, the annuity, to the grantor each year during the trust term. The grantor can select the term of the trust and the annuity to be paid to him. The value of the grantor's retained interest (the annuity) will be subtracted from the value of the property transferred to the trust to determine the amount of the gift. These trusts are used primarily to transfer future appreciation in property after it is transferred to the trust, therefore, assets which are anticipated to have great appreciation are the preferred assets to transfer to a GRAT.

During the primary term of the trust, the grantor can only select the amount of the annuity and the term, all other provisions are prescribed by the statute. After the primary term, the grantor can have the trust continue. The grantor can select a variety of different provisions for the

extension trust which continues after the primary term.

Charitable Remainder Trust

A charitable remainder trust is a trust which provides for the distribution of a specified amount (charitable remainder annuity trust) or percentage (charitable remainder unitrust) to the grantor or some other specified person (recipient) each year. The trust continues for a term of years up to 20 years or the life of the recipient. The property remaining in the trust at the end of the term passes to a charity. If the grantor names a person other than himself as the recipient of the specified amount/percentage from the trust, then the grantor will have made a taxable gift to that person upon creation of the trust. The grantor receives a charitable tax deduction for the actuarial value of the remainder which will pass to charity. The value passing to charity must be at least 10% of the value of the property contributed to the trust.

The terms of these trusts are set forth in the statute. The IRS regulations include an approved form for the trust document. The grantor has very little flexibility in setting any of the terms. The grantor can select the charity and can retain the right to change the charity receiving the property at the end of the term.

Charitable Lead Trust.

A charitable lead trust is a trust which provides for a specified amount to be paid to one or more charities each year. The remainder is generally distributed to the grantor's children or a trust for the grantor's children. There are two types of charitable lead trusts; charitable lead annuity trusts or charitable lead unitrusts. A charitable lead annuity trust provides for the payment of a specified amount or a specified percentage of the initial value of the trust to the charity each year. A charitable lead unitrust provides for a payment of a percentage of the value of the assets held in the trust each year. In other words on the unitrust the amount paid to the charity will vary each year depending on the value of the assets.

The type of charitable lead trust used most frequently in estate planning is the charitable lead annuity trust. The charitable lead annuity trust can either be a grantor trust so that the income is taxed to the grantor each year or a non grantor trust so that the trust is a separate taxable entity. The non grantor trusts provides more benefits in estate planning. The non grantor trust is used in two main situations. First, if the grantor is making gifts to charity in excess of the amount which he can deduct each year, the charitable lead trust can provide current tax benefits to the grantor. The grantor is not taxed on the income received by the trust and the trust receives an unlimited deduction for amounts paid to charity. The deduction is not limited by the grantor's percentage limitations or by the phase out of charitable deductions. The grantor can shift part of his taxable income to the trust and thus practically speaking obtain a full deduction for all amounts paid to charity.

The non grantor charitable lead can also be used to transfer wealth to the grantor's children. If the grantor has property which is appreciating at a rate greater than the applicable federal rate in effect at the time the trust was created, the excess amount is accumulated in the trust and distributed

to the remainder beneficiaries at the end of the trust term. For example in July, 2003, the rate applied to a transfer to a charitable lead trust reached an all time low of 3%. This situation provided an ideal opportunity for charitable individuals to maximize the amount of their charitable deductions and to transfer property to their children tax free.

Defective Grantor Trust.

A defective Grantor Trust is named for a structure which causes the trust income to be taxed to the grantor. A trust which is structured so that the income is taxed to the grantor is referred to as a "defective grantor trust". The reason the trusts are referred to as "defective" is that, historically, including a provision which caused the income to be taxed to the grantor was a mistake; hence, they referred to the trust as defective. However, with the compressed tax rates applied to trusts which we have today (reaching the maximum income tax bracket at under $10,000) structuring the trust so that the income is taxed to the grantor is beneficial. The trust rate of the grantor will not be any higher than that of the trust, more property will be preserved in the trust (since the trust will not pay the tax on its income) for transfer to the grantor's family, the payment of the tax would be considered a tax free gift to the trust beneficiaries, and the grantor can sell assets to the trust without recognizing any gain (since a person cannot be taxed on the gain on a sale to themselves).

These trusts can have any variety of beneficiaries and terms. The grantor can create the trust for the benefit of family members, relatives or friends. The trust can benefit one or more individuals or any group of individuals. The trust could also be a Crummey trust and could be a generation skipping trust.

Although some types of trusts are designed to qualify for special tax treatment under the Internal Revenue Code, most trusts can include a broad range of provisions to fit the grantor's particular desires. The grantor may create a trust for a number of specific reasons. Trusts can provide benefits to one person but hold the property in tact for distribution to another person. For example, in a second marriage, the grantor may want to provide for his wife for her lifetime, but upon her death wants the property to pass to his children (not hers). Property held in a trust which is created by a person other than the beneficiary cannot be reached by the beneficiary's creditors if the trust includes a spendthrift clause and does not give the beneficiary broad powers over the trust. Property held in trust also cannot be reached by an estranged spouse in the division of the property in the event of divorce. The property can be held in trust for the benefit of a child until the child is sufficiently mature to handle the trust.

BYPASS TRUST, EXEMPTION TRUST, B TRUST and FAMILY TRUST

What do I call thee, let me count the names. Bypass Trust, Exemption Trust, B Trust, and Family Trust are all the same type of trust. Prior to the tax act in 1997, the trust was also called the exemption equivalent trust or the credit shelter trust. This trust is the most basic tool in estate planning to reduce estate taxes for a married couple.

Let me begin with a little background. Most people do not need any tax planning in their Wills. The use of this trust saves taxes when a couple has a combined estate including insurance of more than the individual exemption, $1 million in 2003. How many people fall into this category? 1989 IRS figures reflect that in that year, only 2% of the individuals who died had an estate of over $600,000 (the exemption from estate tax in 1989) and only 7/10 of 1% had an estate of over $1 million. The rate of growth of estates since that time has been dramatic. In the April 1997 issue of American Demographics, the magazine noted that the number of individuals having an estate of over $1 million more than doubled between 1992 and 1996. The Millionaire Next Door stated that 3% of the households in America have a net worth over $1 million. Suffice it to say, even with the dramatic increase, the number is still very small. But if you are reading this booklet, you are probably in that small percentage.

1989...only 2% of the individuals who died had an estate of over $600,000 (the exemption from estate tax in 1989) and only 7/10 of 1% had an estate of over $1 million.

Let's assume that you and your spouse have a combined estate of $2,000,000 (twice the amount of the 2002 and 2003 exemption of $1 million). Therefore, each of you can give $1 million tax free. So no problem - right? Right, as long as you do not give anything to each other. Generally, a simple Will gives all of the property to the survivor outside of any trust and then provides that upon the survivor's death, the property is split among the children of the couple. In our example, this plan will result in an estate tax of $435,000 upon the death of the survivor if he/she died in 2003 (or after 2010) since the survivor has an estate of $2,000,000 and can only give $1 million without tax.

...assume that you and your spouse have a combined estate of $2,000,000...each of you gives all of the property to the survivor... resulting in an estate tax of $435,000 upon the death of the survivor

Let's assume one marriage, one set of children, each spouse having the ability to manage property - in other words we are not trying to control the spouse’s use of the property, manage it for him/her or ensure that *our* (as opposed to his/her)

children receive the property. Our objective in this situation is to give the survivor as much control over, and use of, the property without causing the property to be taxed in his or her estate. Enter the Bypass Trust.

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The Bypass Trust is a trust that is created upon the death of the first spouse to die. The provisions for the Bypass Trust are included in your Will or Revocable Living Trust. Your Will or Revocable Living Trust provides that you give an amount of property equal to the amount of the exemption to the Bypass Trust. A dollar amount is not used since the amount of the exemption can change and, in fact, is changing almost every year for the next eight years. The exemption is increasing over the next several years reaching $3.5 million in 2009, unlimited in 2010 and reverting to $1 million in 2011 as follows:

2004	1,500,000
2006	2,000,000
2009	3,500,000
2010	No estate tax
2011	1,000,000

If more than the exemption amount is placed in the Bypass Trust, a tax will be owed (except in 2010). However, if everything over the exemption amount is given to one's spouse, either outright or in a trust that qualifies as a gift to one's spouse, no tax will be owed. Since 1981, you have been able to give an unlimited amount to your spouse with no tax. This deduction is called the "marital deduction."

OK, so we have created a trust and we transfer property to the trust with a value equal to the exemption. Trusts have a bad connotation that someone else is controlling our money and deciding how much, if anything, that we should get. Well, that should never be the case, but that is another discussion. In this trust, we started with the premise that we would give our spouse the entire estate outright; we are not trying to protect our spouse from himself/herself, nor are we trying to preserve the property for distribution to our children.

> ...if she had the power to distribute the property to herself for her “comfort?" ...she could say that it comforts her to give the property to charity, to her new spouse, to her boyfriend, or to buy a Rolls Royce....the power is too broad and is considered by the IRS to be the equivalent of outright ownership, and the trust assets will be included in her estate...

The trust is managed by the Trustee. The Trustee has the power to manage the property, decide on the investments and make decisions concerning the amount of the trust income and principal that is distributed to the beneficiaries. In other words, the Trustee has “Control”. Our spouse wants “Control”, so we name our spouse as the Trustee of the trust.

We also want our spouse to receive distributions from the trust and to be able

to use the property for his/her support. Our spouse is the beneficiary of the trust. Our spouse is either the only beneficiary of the trust, or if we also name our children as beneficiaries, then our spouse is the primary beneficiary of the trust.

Are there any restrictions, any catches to this structure? There is one restriction. If our spouse is the Trustee and the beneficiary and can distribute principal to herself/himself, then the trust must provide that the principal can be distributed only for certain purposes. The

> If our spouse is the Trustee and the beneficiary and can distribute principal to herself/himself, then the trust must provide that the principal can be distributed only for certain purposes.

trust must provide an "ascertainable standard"; in other words, something which can be determined and enforced by a court. The most typical "ascertainable standard" is "health, education, support and maintenance according to her standard of living." If the trust contains this provision, then the spouse can be the Trustee and the beneficiary, and the property will not be included in the spouse's estate upon her/his death.

Note that the distribution for her support is according to her standard of living, so that distributions can be made to maintain the same living standard that she had while her spouse was alive. You may wonder then what is not considered "for her support." Well, she cannot distribute the property to someone else (e.g. subsequent spouse) or charity. She also cannot increase her standard of living. If she drove a Lexus and spent $150,000 per year on her living standard, she cannot now use the trust money to buy a Rolls Royce and spend $300,000 per year. However, she can use the money she has outside of the trust to buy the Rolls Royce and increase her standard of living. I'm not recommending this course of action, but she could do this.

What if she had the power to distribute the property to herself for her "comfort?" Since one could say that one needs any amount of money for one's comfort, your spouse could say that it comforts her to give the property to charity, to her new spouse, to her boyfriend, or to buy a Rolls Royce. Therefore, the term comfort is not considered an "ascertainable standard." If your spouse can distribute the property to herself for her comfort, the power is too broad and is considered by the IRS to be the equivalent of outright ownership, and the trust assets will be included in her estate, thereby losing all of the benefits of the trust.

> In the situation outlined here, the Bypass Trust is a win/win choice.

Can we give our spouse any other type of power over the trust?

Yes, we can give our spouse the power to change how the property is distributed upon her death. As long as she cannot direct that the property be distributed to herself, her estate, her creditors or creditors of her estate, having this power will not interfere with any of the tax benefits of the trust. Although you will probably want to restrict the persons to

whom she can give the property, you could have the power be so broad that she could give the property to a subsequent spouse or to charity. Generally, this power is limited so that she can change the manner in which the property is distributed to your children (e.g., hold the property in trust for a period of time), but she cannot give it to people outside of your family. This power is called a "special power of appointment."

Let's assume we've set up the Bypass Trust and funded it with the exemption amount. Let's also assume that our estate was not just $2,000,000 but was $4 million total. $1 million would be held in the Bypass and our spouse has property valued at $3,000,000. On her death, a tax of up to $945,000 will be owed depending on the year of our spouse's death. First, we recommend that she live to at least 2009 and that Congress votes to retain the $3.5 million exemption. What other type of planning would be helpful in this event to reduce the tax which is owed?

The property in the Bypass Trust will not be included in our spouse's estate upon her death, but the property is always available to her. The property is not taxed on our spouse's death even if the property has doubled or tripled in value. Hmmm, this leads to a plan. Let's say that our entire $4 million estate yields an income of $150,000 per year, the exact amount of money our spouse needs to maintain her standard of living and has non income producing growth assets. If we transfer $1 million of growth assets to the Bypass Trust, our spouse retains the income assets and the growth will not be included in her estate. If our spouse needs additional funds, it is better for our spouse to use assets outside of the trust since these assets will be included in her estate.

> ...we can give our spouse the power to change how the property is distributed upon her death.

In the situation outlined here, the Bypass Trust is a win/win choice. The spouse need only maintain a separate account for the trust and file separate tax returns for the trust. She can manage the property and can use the property for her support if she needs it and save hundreds of thousands of dollars in taxes for your children in doing so.

WHAT IF REPEAL STAYS? IS THE BYPASS TRUST GONE ALSO?

The short answer is, definitely not. First, the trust also provides benefits for the spouse such as protection from creditors and from estranged future spouses (an area where we definitely want to protect our spouse). In addition, even with a full repeal of the estate tax for an indefinite period (i.e. no automatic reinstatement) cannot be counted on to last. With a budget shortfall, a different economic climate and a different mix in Congress, a tax law protecting only a fraction of the top 1% is likely to be targeted. The Bypass Trust will continue to be a protection to our families from creditors, estranged spouses and potentially, from taxes.

WHAT ABOUT A LIFETIME BYPASS?

Sounds like heart surgery. Some people may prefer to have surgery than give property away during their lifetime. However, one of the points I keep making in my discussions are the benefits of

compounding. Several years ago, a couple in their 80s came into my office for estate planning. They had an estate of about $1.3 million, all community, no tricky aspects like a large retirement account. I prepared Wills which created Bypass Trusts for each of them. Fast forward three years, I receive a call. One of their main assets was Dell stock. Their estate was then worth over $4 million. Whoa, was there a way to have frozen our estate at $1.3 million and avoided all tax several years ago? Yes, and no. There are ways to transfer the appreciation on assets to our children. E.g. see the discussion on "Grantor Retained Annuity Trusts" and "Defective Grantor Trusts."

But this couple wants to retain the property for *their own* use and not give it to their children. They do not know what their future needs will be. Taking a step like transferring all appreciation to their children would be a case of having the "tax tail waging the dog". Could they transfer property to a Bypass Trust during their lifetime? I have used this technique, but there are a number of caveats in taking this step. First, if I create a trust for you with $100,000 and you create a trust for me with $100,000. The IRS says these are "reciprocal trusts" and it is treated as if I created a trust for myself with $100,000 and you created a trust for yourself with $100,000. If interpreted as a trust that I create for myself, the entire trust is included in my estate, no benefit gained. However, let's make the trusts different. Maybe only my children are beneficiaries for the first ten years of the trust and then I become a beneficiary. You are the sole beneficiary of the trust I create for you. These trusts should be considered sufficiently different not to be treated as reciprocal trusts. However, this hurdle is only one of the hurdles in this situation. Let's return to our couple. Let's assume each of them creates a trust for the other and we have made the trusts sufficiently different to avoid the reciprocal trust rule. When one of the spouses dies, only one trust is left. If husband creates a trust for wife and wife creates a trust for husband, when husband dies, only the trust for wife remains since wife has given her half of the property to husband and he is now deceased. If the couple divorces the same effect occurs, it's as if you have preplanned a division of property on death or divorce. Bottom line, these trusts may be extremely beneficial but the circumstances in which they fit are very limited.

This couple wants to retain the property for *their own* use and not give it to their children.

In addition to the caveat of the impact of divorce, the couple must have sufficient funds to give the exemption amount directly to their children. If the couple is in this position, losing the benefit of one of the trusts upon one of their deaths (or divorce) will not affect them. Second, the differences in the two trusts must be compatible with the couple's needs. Generally, situations in which the creation of trusts structured in this manner works are ones which are used in an estate in the $2 to $5 million range or in a situation where the trust is funded with a relatively small amount of property with the potential for dramatic appreciation.

Generally, situations in which the creation of trusts structured in this manner works are ones which are used in an estate in the $2 to $5 million range or in a situation where the trust is funded with a relatively small amount of property with the potential for dramatic appreciation.

QTIP TRUST

A QTIP trust. What a name. I guess when you have an area as dry as the tax aspects of estate planning, you have to have strange names in order to spice things up. QTIP is the acronym for qualified terminable interest property. That really doesn't help. Okay, how about an overview with some background to put the concept of this type of trust in context, then we will discuss its uses.

The QTIP trust is a trust in which the surviving spouse is the sole beneficiary during his/her lifetime and receives all of the income from the trust for his/her lifetime. A gift to one's spouse in a QTIP trust qualifies as a gift to one's spouse and is considered deductible when determining the estate tax owed on your death. Upon your spouse's death, the trust assets are taxed at your spouse's highest marginal rate. The property remaining in the trust after payment of the estate taxes passes to the person or persons you designated in your Will. In other words, the trust enables you to defer the tax on the property until your spouse's death and still control to whom the trust assets will pass upon your spouse's death. The only requirement is that your spouse receive all of the income from the trust each year.

> ...enables you to defer the tax on the property until your spouse's death and still control to whom the trust assets will pass upon your spouse's death.

I have said it all, so let's just close this chapter right here. Of course, I can't do that because I haven't told you why this trust is so important from an historical perspective. Ho, hum.

Prior to 1981, you could only give your spouse one-half of your separate property tax free. The gift to one's spouse was referred to as the marital deduction, since the amount given to one's spouse (up to one-half of your separate property) was deductible in determining the tax owed on your estate. The purpose of the deduction was to put separate property states on a parity with community property states where the surviving spouse owned one-half of the community. In order to qualify for this deduction, you had to give the property outright to the spouse or place it in a trust in which the spouse's interest did not terminate. The spouse had to have the power to direct the distribution of the property upon his/her death.

> The main requirement is that all of the income be paid to your spouse each year. You cannot provide that your spouse ceases to be a beneficiary of the trust should he/she remarry.

In 1981, the law was changed to allow you to give your spouse your entire estate

without tax. Under prior law, in order to qualify for this deduction, you would have had to give your spouse the power to dispose of this property in his/her Will. This requirement created a difficult decision - pay the tax or allow your spouse to cut out your kids (or other intended beneficiaries). So, Congress decided to create a special type of trust in which your spouse's interest did terminate, allowing you to control the distribution of the trust upon your spouse's death. This trust was called the Qualified Terminable Interest Property Trust. Any other marital trust you use requires that the spouse have the power to dispose of the property upon his/her death. As you might guess, the other types of marital trusts are rarely used. The main requirement is that all of the income be paid to your spouse each year. You cannot provide that your spouse ceases to be a beneficiary of the trust should he/she remarry.

> Under prior law, in order to qualify for this deduction, you would have had to give your spouse the power to dispose of this property in his/her Will....created a difficult decision - pay the tax or allow your spouse to cut out your kids

Do you have to leave the property in a QTIP trust in order to get the deduction? No. You can give your estate to your spouse outright. The problem with giving the property to one's spouse outright is that your spouse may give the property to his/her subsequent spouse (I wasn't sure how to say second, third or fourth spouse in a tactful manner) or if you both have been married before, then to her children rather than to your children. So the main benefit of the QTIP trust is control.

> ...the main benefit of the QTIP trust is control.

In summary the QTIP trust is:

< A trust for the benefit of the surviving spouse for his/her lifetime.

< The trust must provide that all of the income received by the trust is distributed to the spouse each year. The trust may provide that the spouse can receive the principal of the trust.

< The property is included in the surviving spouse's estate and is taxed upon the surviving spouse's death.

< The property is protected from creditors.

< The main benefit of creating the trust is control -

> Control over the distribution of the assets during the spouse's life (with the exception of the income), the principal can be restricted or restricted upon the occurrence of certain events (e.g., remarriage)

> Control over the management of the assets for a spouse who is not capable of managing the

property and/or is not fiscally responsible.

> Control over the distribution of the trust assets upon the death of the surviving spouse.

The benefits of the trust also describe its uses. It is not used to eliminate tax upon your death since an outright gift would do that. It is most frequently used to control the distribution of the assets upon the death of the survivor and, to a lesser extent, to restrict the use of the funds during the survivor's lifetime.

Why are there two QTIP trusts in my plan? You have reviewed your plan and noticed that your plan includes a Bypass Trust, a Marital Deduction Generation Skipping Trust and a Marital Deduction Trust. Both of the Marital Deduction Trusts are QTIP trusts. You will specify how the property in each of these trusts is distributed upon your spouse's death.

Why are there two QTIP trusts in my plan?

Let's back up a bit, and discuss a little of the structure of the generation skipping trusts. A more lengthy discussion of the generation skipping trust is in another chapter, but a brief summary is needed here. Generation skipping trusts do not skip a generation in terms of the benefits provided, but do skip taxation in your children's estate. The trust provides for your children to receive income and principal from the trust, to the extent needed. This type of trust was so beneficial in providing one's children with full benefits from the trust's assets, but was not taxed upon their death, that a new tax was created, enter the generation skipping tax. The generation skipping tax is a tax in addition to the estate or gift tax and is a flat tax at the highest estate tax rate, 49% in 2003. This tax has eliminated the benefits of this type of trust in almost every situation. However, each person has a $1,120,000 exemption from this tax in 2003. Since the trust can be structured to provide benefits for your children, avoid tax, protect the assets from creditors and, to some extent, from estranged spouses, it is very advantageous to use this trust as much as one is able.

Now let's return to the two QTIP trusts in your estate plan.... If you have not used all of your exemption during your lifetime, your plan sets up a Bypass Trust. Part of your $1,120,000 exemption is allocated to this trust. The remaining portion of your $1,120,000 exemption is held in one of the QTIP trusts. For example, let's assume that your Bypass Trust holds $650,000 (since you made gifts using $350,000 during your lifetime). If you have not used any of the generation skipping exemption during your lifetime, then one of the QTIP trusts will hold $470,000 and the remainder of your $1,120,000 generation skipping exemption will be allocated to this trust. This trust is the one which is referred to as the Marital Deduction Generation Skipping Trust.

All the rest of your property (your separate property and your half of the community over $1,120,000) is held in the Marital Deduction Trust.

The terms of each of these Marital Trusts is identical. The only difference between

the trusts is that upon your spouse's death, the Marital Deduction Generation Skipping Trust is combined with the Bypass Trust and divided into separate trusts for your children which will continue for their lifetime. The Marital Deduction Trust is distributed to your children outright or to trusts for your children which will be distributed to them at a certain age and/or be taxed in their estate.

Beginning in 2004 the estate tax exemption and the generation skipping tax exemption are identical. Creation of two Marital Trusts will only occur if you use part of your estate tax exemption during your lifetime or, if you die after 2010 and the law has not been changed .... Doesn't the structure of the estate tax law with the sunset provision in 2011 make everything in this area even more confusing?

LIFE INSURANCE TRUST

The Irrevocable Life Insurance Trust is one of the most beneficial estate planning tools available. The purchase of life insurance in an irrevocable life insurance trust is a key element in most of the highly advertised books and seminars on how to eliminate estate taxes.

Life insurance can provide the resource needed to support the surviving spouse, raise and educate minor children, provide liquidity to pay estate taxes and replace part or all of the estate lost to estate taxes. However, it can make a nontaxable estate taxable and can generate additional taxes when its purpose is to pay the taxes on the current estate -- unless the life insurance ownership and beneficiary designation are structured to avoid having the proceeds included in the insured's estate.

> ...[A]n irrevocable life insurance trust is a key element in most of the highly advertised books and seminars on how to eliminate estate taxes.

For example, on a $2 million all community estate, the addition of $500,000 in life insurance can cause the imposition of a tax of $225,000 if the individual dies in 2002 or 2003. Likewise, in an estate in the 50% tax bracket, $500,000 of a $1 million policy purchased to pay the taxes could be lost to tax.

The Irrevocable Life Insurance Trust (ILIT) is intended to provide the structure to avoid having the insurance included in the individual's estate while still retaining its availability for the purpose for which it was purchased. The ILIT is very successful at meeting this objective. However, the Irrevocable Life Insurance Trust has two disadvantages. First, it is irrevocable. The terms of the trust cannot be changed. In addition, its benefits are gained from a little legal maneuvering through a technical and obscure set of IRS rules, not just in the initial structure but in funding the trust each year. Meeting the IRS rules requires certain procedures to be followed and paperwork to be maintained. These technical "hoops" will be explained in this chapter.

Let's look at what we want to accomplish. Our objective is to provide all the benefits for which we purchased the policy (e.g. support for our spouse and children and/or to pay estate taxes) and do so without incurring any transfer (estate, gift and generation skipping) taxes. To keep the insurance out of our estate we must not have any "incidents of ownership" over the policy, and our estate must not be named as beneficiary on the policy. The latter is not difficult. However, being named as the owner, having the power to change the beneficiary and/or having the power to use the cash value are all incidents of ownership. Therefore, we need to transfer all ownership rights to another person. If we transfer all ownership rights to our spouse, we have avoided having the life insurance policy

taxed in our estate, but it will still be taxed in our spouse's estate.

Enter the Irrevocable Life Insurance Trust.

We want the trust 1) to provide for our spouse and our children 2) not be included in our estate, 3) not be included in our spouse's estate and 4) not be subject to gift taxes when we transfer money to the trust to pay the premiums. Can we accomplish these objectives? Yes, but we must jump through several hoops to get there.

Hoop #1 - The policy must be owned by a trust in which the insured is not a beneficiary and over which the insured has no control.

Jump #1 - We transfer all of our ownership rights to the trust, or the trust purchases the insurance policy. We relinquish any control over the insurance policy by appointing someone other than ourself as the Trustee of the trust. Since the trust won't have much money in it until we die, not being the Trustee is generally not a problem.

> Hoop #1 - The policy must be owned by a trust in which the insured is not a beneficiary and over which the insured has no control.

If we transfer an insurance policy to the trust, the insurance will be included in our estate for a period of three years following the transfer. If the trust is the original purchaser of the policy, the policy is excluded from the insured's estate from the date of purchase. If the policy is purchased by the trust, the trust should be the original applicant on the policy.

Let's assume one of our purposes in creating the trust is to provide for our spouse. Therefore, we want our spouse to have the benefit and control over the proceeds from the insurance. Can our spouse be the Trustee and keep the insurance proceeds out of his or her estate?

> We want the trust ... to provide for our spouse and our children ... [and] not be included in our estate...

Hoop #2 - Only the insured's separate property can be placed in the trust if the spouse is a beneficiary of the trust.

Enter one of the technicalities that affects the transfer to the trust of the policy and/or the funds to pay the premiums on the policy. Normally, we would use part of our earnings to pay the premiums on the life insurance. Our earnings are community property. That seems irrelevant, but it isn't. Community property is deemed to be owned one-half by each spouse. If we transfer property to another person (or a trust) and retain the right to receive the income from that property, the property is included in our estate. So, when we create a trust of which our spouse is a beneficiary and transfer community property to the trust,

> Hoop #2 - Only the insured's separate property can be placed in the trust if our spouse is a beneficiary of the trust.

our spouse has retained an interest in his or her one-half of the community which was transferred to the trust. We thought we had avoided tax on all of the property by the creation of the trust, but now we have brought one-half of it back in to our spouse's estate.

Can we avoid this result? Yes, simply transfer our separate property to the trust. And what if we don't have any separate property? Create some.

Jump #2 - You can partition community property into two parts, one part is our separate property and one part is our spouse's separate property. The partition must be evidenced by an instrument in writing. Every contribution to the trust must be of the insured's separate property.

> We want the trust...not to be included in our spouse's estate...

Our next objective is to avoid all gift taxes on the transfer to the trust. We can avoid gift tax on the transfer, if we jump through another hoop.

Hoop #3 - Give one or more of the beneficiaries the right to withdraw each and every contribution for a period of at least thirty days.

A gift tax applies to any transfer we make to a person or a trust. In order to exclude relatively small transfers from the transfer tax system, each of us can give up to $11,000 each year to as many people as we want. However, if we give someone $11,000 per year for five years with the restriction that they cannot have the gift until the end of five years, the IRS says we have not given that person $11,000 a year, we have given them $55,000 plus interest at the end of five years. The individual must have the ability to use the money at the time of the gift. This requirement is called the "present interest" requirement. The individual must have a "present interest" in the money we have given them. In a trust, our intent is to provide funds for use at a later time, so it seems we can't meet this present-interest requirement.

> We want the trust ...not be subject to gift taxes when we transfer money to the trust to pay the premiums.

Jump #3 - We create the "present interest" by giving the beneficiaries the right to withdraw the property contributed to the trust for a specific period of time. If they do not exercise their right to withdraw the money, their right lapses, and they may not withdraw the funds at a later time. The Trustee must send written notices of each and every contribution to the beneficiaries.

About twenty years ago, a taxpayer created one of these "withdrawal right" trusts and gave his minor children the right to withdraw the contributions. The IRS argued that the children were too young to be aware of the withdrawal right and thus the right was illusory. The IRS lost and these trusts have come to be known by the name of the taxpayer, Mr. Crummey. Hence, a Crummey trust is a trust which gives the beneficiaries the right to withdraw each contribution for a period of time, not a trust which was poorly drafted.

These are the hoops for a trust created to own life insurance on our lives to provide for the support of our spouse and our children.

What about a trust which is solely for the benefit of our children or intended solely to provide cash to pay the estate taxes on the death of the survivor of me and my spouse? Yes, this can be an Irrevocable Life Insurance Trust, but some hoops remain.

> Hoop #3 - Give one or more of the beneficiaries the right to withdraw each contribution for a period of at least thirty days.

Frequently this type of trust is a generation skipping trust, sometimes called a Dynasty Trust. The generation skipping trust is a trust which provides for our children and continues for their lifetime, thereby avoiding estate tax in their estates as well as providing protection of these assets from the claims of creditors and, to some extent, from estranged spouses. See the discussion concerning generation skipping taxes in the chapter titled "Transfer Taxes - An Overview" and see the discussion later in this chapter titled "Generation Skipping Trusts".

First, since our spouse is not a beneficiary, the trust does not need to be funded with separate property. We can eliminate that hoop.

Purchasing life insurance in a generation skipping trust may enable us to "leverage" the use of our $1 million generation skipping exemption from generation skipping tax. The ability of the purchase of insurance to leverage the use of our generation skipping exemption depends on several factors. One factor is the proper and timely allocation of a portion of our generation skipping exemption to the trust as discussed below. The leveraging ability also depends on the untimeliness of our death and on a comparison of the investment of the premium were life insurance not purchased.

Of course, we would like to maximize the use of our generation skipping exemption. Indeed, in estates which are larger than $1 million ($2 million for a couple), we have property which cannot be left in this type of trust without subjecting it to the generation skipping tax. With a life insurance trust, we may contribute $200,000 in premium payments over a 10-year period and purchase $2 million in life insurance. However, we must take the steps necessary to ensure that our generation skipping exemption is allocated to the contributions made to the trust each year during our lifetime. If our exemption is not allocated during our lifetime, the exemption will be allocated to the trust upon our death - whoops, we don't have enough exemption to allocate to the $2 million in proceeds. The result will be that the trust will be partially subject to the generation skipping tax. Not a result that we want.

> Purchasing life insurance in a generation skipping trust enables us to "leverage" the use of our $1 million generation skipping exemption from generation skipping tax.

Prior to 2001 exemption was only allocated to a transfer to a trust if there were no beneficiaries who were not "skip" persons. In other words, the trust must be solely for the benefit of grandchildren and more remote generations. If the trust was structured like most generation skipping trusts, ones children were beneficiaries during their lifetime. Prior to 2001 a gift tax return was required to be filed to allocate generation skipping exemption to any contribution to the trust. Many people were not aware of this requirement or failed to allocate exemption each year. The 2001 Tax Act changed the automatic allocation rules to address this problem. The automatic allocation rules are far too complex to discuss in this booklet, but for our purposes it is important to note a couple of aspects of the law. First, the intent was to automatically allocate generation skipping exemption to trusts which continued for our children's lifetime; however, some of the exceptions can catch us so it is unsafe to rely on automatic allocation. Second, the new law allows us to file a gift tax return when the trust is created and elect "in" or elect "out" of automatic allocation of the generation skipping tax exemption.

Enter a new hoop - file a gift tax return when the trust is created and elect for the automatic allocation rules to apply to the trust.

Jump through hoop - When a generation skipping trust is created, a gift tax return should be filed allocating part of our generation skipping exemption to the trust and electing that the automatic allocation rules apply to the trust in the future.

In our above example, if our exemption were allocated to the premium payments, we would have created a $2 million generation skipping transfer using only $200,000 of our exemption. Very nice leveraging --

Wait a minute, isn't all that money going to be used to pay the estate taxes on the death of the survivor of me and my spouse? Well, the trust does not actually *pay* the estate taxes. The trust purchases assets from the estate of the survivor. The estate has the cash to pay the estate taxes and our generation skipping trust owns $2 million of the assets we owned at the time of our deaths.

Very beneficial, very slick -- that's why they are so highly touted - the secret you see in the advertisements on TV are now revealed. Now you don't need to order the book -

GENERATION-SKIPPING TRUST

A generation-skipping trust - what is it? First of all, it is a misnomer. The term sounds like it is a trust which skips your children and benefits only your grandchildren or more remote descendants. Although this type of trust would be a generation-skipping trust, the type of generation-skipping trust I want to talk about is primarily for the benefit of your children. The trust has come to be referred to as a generation-skipping trust since it "skips" taxation in your children's estates. This type of trust can be used for your children even if your children have no children. If your children have children, then the generation-skipping tax (discussed at the beginning of this chapter under the title "Transfer Taxes - An Overview") limits the amount of property you can leave in this type of trust.

Trusts created upon death

Leaving property in trust for our grown children may feel like “ruling from the grave” - so we decide that our death is the time to relinquish control to our children. We give all of our estate outright to our children. We do not give any property to our grandchildren, we leave that decision to our children. We do not leave the property in trust. We do not want to restrict our children's use of the property we leave them. With this purpose in mind, you may be inclined to skip this chapter. Please don't.

> The ... generation-skipping trust ... is a trust in which your children can “have their cake and eat it too.”

As you'll see, your child actually has *more* control with the type of generation-skipping trust I discuss here. The type of generation-skipping trust I discuss in this chapter is a trust in which your children can “have their cake and eat it too.” Although this discussion is by no means exhaustive, the points raised here will give you a flavor of the type of trust you can create.

Let's assume that your children are all responsible adults. You are close to your children and would like them to be the primary beneficiaries of your estate upon your death. Your intent is to divide your property equally between your children and give them all of your estate outright. Our objective will be to provide a trust which provides as many benefits of outright ownership as possible with as much additional protection as possible, including preventing the property from being taxed in your child's estate for tax purposes.

> [A] generation-skipping trust increases the control your child has over the property....

But estate tax savings are not the only savings. In fact, even when tax savings are completely irrelevant, these trusts still provide significant benefits which many of us would enjoy and many of us would like to provide for our children. What are some of these other benefits? Creditor protection and some estranged spouse protection. Ahh, the benefits begin to look more attractive. By protecting the assets held in the trust from the claims of creditors and, to some extent, from estranged spouses, a generation-skipping trust actually increases the control your child has over the property. Think of control as the ability to determine the investment and the use of your assets unfettered by claims of third parties.

Let's look at some of the changes in society as well as the laws which have increased the attractiveness of this type of trust. In the 1980s we experienced an economic boom, particularly in the real estate and oil and gas markets. Leverage was the name of the game, and property could not be acquired fast enough. Then the bottom fell out of the market. The savvy businessmen who could increase their profits exponentially with leveraging - scrambled. Some of them were able to pull themselves out - some went under, some went into bankruptcy, many lost most of their net worth. Perhaps it can happen to me or my family .....

> The security that you could work hard, save, invest wisely and retire in comfort could be wiped out through a single lawsuit.

During this same period, lawsuits proliferated. Personal injury lawsuits, malpractice lawsuits -- sometimes it almost seemed like "gee whiz, I need some money, and you have some" lawsuits. Insurance companies have become more reticent to insure and have increased their premiums for insurance. The security that you could work hard, save, invest wisely and retire in comfort could be wiped out through a single lawsuit. Statistically unlikely, but a scary thought. Perhaps it can happen to me or my family .....

And social security? As mentioned in this booklet earlier, a statement at a seminar I attended to the effect that "more people believe in UFOs than in social security" pretty much sums it up. Will it be there for us? Will it be there for our children? Perhaps it can happen to me or my family .....

Another increasingly frequent occurrence is divorce. Marriages used to be for a lifetime. Many of us who felt that way are among the ranks of the divorced. We may love our son-in-law or daughter-in-law, but for most of us this affection comes largely from their relationship with our child. As long as you make my child happy, I love you. If you hurt my child, leave my child - all bets are off. To add insult to injury, the estranged spouse may claim that the money we have given our children has been "commingled" with the couple's other property and now has become community property. An insult to watch, but a travesty if we have already died and our child's retirement security nest egg is taken away. Perhaps it can happen to me or my family .....

These are the situations from which we want to protect our children. We want our property to help our children, give them the security in their lives, the extras in their lives without interference from others. Have I piqued your interest? as a parent? as a child of a parent from whom you will inherit?

What is a trust? A trust is an agreement between two people to hold property for the benefit of another person. The parent creates a trust, usually created on their death, with the terms set forth in their Will or revocable living trust. The parent requests another person, the Trustee, to hold money for the benefit of the beneficiary. The Trustee is the one who has control over the management and investment of the property and distributes the income and principal to the beneficiary according to the terms of the trust. The parent decides on the terms of the trust. Our objective is to give the child as much control over the property and benefit from the property as possible, and still gain the benefits of estate tax avoidance, creditor protection, and estranged spouse protection.

> To add insult to injury, the estranged spouse may claim that the money we have given our children has been “commingled” with the couple’s other property and now has become both of their property.

First, we want the child to have control over the management and investment of the property; therefore, we want each child to be the Trustee of his/her own trust. We want the child also to be the beneficiary of the trust so the trust will provide that the trust income and principal may be distributed to the child. If the child is the Trustee, then the distribution of principal must be limited to distributions for the child's "health, education, support and maintenance according to his/her standard of living." Since the type of distributions are determined by the child's standard of living, I have not found this provision to be too limiting. The child can have the power to designate who will receive the remaining trust assets upon his/her death, with the only limitation generally being that the child cannot designate that the property be distributed to his estate or to the creditors of his estate. This limitation is also important from a creditor protection standpoint. In addition, to provide protection from creditors, the trust must have a spendthrift clause prohibiting the beneficiary from pledging the assets as collateral on a loan or assigning an interest in the trust to creditors.

Protecting the assets from estranged spouses provides some additional planning. Income earned on separate property is community property. If all of the income of the trust is distributed, then the property remaining in the trust is protected as his/her separate property just as it would be if the child owned the property outside the trust, since the court cannot "divest" or take away a spouse's separate property. By holding the property in a trust, the property is kept segregated from the couple's community avoiding the risk of commingling the separate and community property.

However, if the income is not distributed and the child is the Trustee of the trust, then there is a risk that the income will be considered community property and the community property could be mixed with the separate property in the trust, thereby enabling the spouse to make a claim against the assets in the trust. This area of the law is not clear. To avoid this risk, I have added a provision in some trusts that no distributions can be made from the trust while a child is married unless his/her spouse signs a marital or premarital agreement in which the spouse waives all rights to the income and/or principal of the trust.

Assuming these trusts are really as beneficial as they seem, then let's leave all of our property in trust for our children. If we are very wealthy with millions or even tens of millions of dollars in assets, the benefits outlined here are invaluable. Ahh, too good to be true? The IRS thought so. At the IRS's urging, beginning in 1976 Congress has tried to cut back the dramatic tax benefits enjoyed from these trusts. The first law which was passed to avoid the tax benefits, was unworkable and, in 1986, Congress passed a new tax -- the generation-skipping tax.

The generation-skipping tax is a flat tax at the highest estate tax level, currently 49%, dropping to 45% by 2007 and returning to 55% in 2011. The tax is imposed on all transfers to grandchildren and all distributions from a trust to grandchildren or more remote generations. The generation-skipping tax is in addition to the estate and gift tax. For example, on a bequest to your grandchildren when the maximum gift and estate tax rate is 50% you could owe a gift tax of 50% and a generation-skipping tax of 50%. However, each person has an exemption from this tax of $1 million adjusted further for inflation and in 2004 and thereafter increased in the same amount as the estate tax. This year each of us can give up to $1.12 million ($2.24 million for both parents) to our children in a "generation-skipping trust." One of the “games” to play in this arena is to maximize the use of the exemption. For a more detailed discussion of the generation-skipping tax see the chapter titled "Transfer Tax - An Overview."

The generation-skipping tax is a flat tax at the highest estate tax level, currently 49%.

Use it or lose it. It is far too beneficial not to be seriously considered. If you will inherit property from your parents, ask them to consider leaving the property to you in this type of trust. If you want to leave property to your children, consider leaving it to them in this type of trust.

Trusts Created During a Lifetime

My primary purpose in writing this section of the Guidebook was to illustrate the benefits of leaving property in trust for your children upon your death. However, if a trust is created during your lifetime, the assets can compound for a longer period of time.

Let's look at how you might use a generation-skipping trust as part of your estate plan. Let me begin by giving you some of the "traditional wisdom". Let's assume you are very wealthy and your children cannot possibly spend the inheritance they will receive from you. In this situation, your generation-skipping exemption is best used on a trust from which your children will never receive distributions. In the remainder of this discussion, I will assume that you do not fall into this category and will structure the generation-skipping trust with the intent that your children will be the primary beneficiaries.

> ..."traditional wisdom"...assume you are very wealthy and your children cannot possibly spend the inheritance they will receive from you. In this situation, your generation-skipping exemption is best used on a trust from which your children will never receive distributions.

One advantage to creating a generation-skipping trust during your lifetime is to fully utilize your $11,000 annual exclusion from gift tax if you are not currently making full use of that amount. Another is to set aside a fund of money which cannot be used to enhance their current lifestyle. You may give your children money when they "need" assistance, but do not make regular gifts to them, or you may give them regular gifts, but not as much as $11,000 per year. Perhaps one of the reasons you do not make larger gifts is that you do not want your children to spend the funds you give them. You would like more control over the availability of these funds. In this situation you can make gifts to a trust for their benefit with the intent that these funds be accumulated and reinvested for their future use. If the intent is to have the funds invested over a long period, then creating a trust which will continue for your children's lifetime is consistent with this objective. In the earlier portion of this section, I suggested that you make your child the trustee of his/her own trust. If one of your desires is to restrict access to these funds, you may prefer to serve as trustee or to have a third person serve as trustee.

However, we do have some hurdles to get over if we want the trust to qualify for the annual exclusion from gift tax. Ahh, you are beginning to get used to this type of digression, aren't you. In order for a gift to qualify for the $11,000 annual exclusion from gift tax, the beneficiary must have a "present interest" in the money or other property given. If the property is given to a trust, the beneficiary does not have the right to use the funds. We create this right by giving the beneficiary the right to withdraw the contribution for a period of time. In the section on Gifts to Minors, I discussed the "Crummey Trust". A Crummey Trust is

> One advantage to creating a generation-skipping trust during your lifetime is to fully utilize your $11,000 annual exclusion from gift tax if you are not currently making full use of that amount.

simply a trust which gives the beneficiary the right to withdraw the amount of the contribution to the trust for a period of thirty days. If you are giving your child $6,000 per year, you can give the additional $5,000 (or if you are married an additional $16,000) to a trust for your child. If you anticipate that your child will use all of the funds in this trust during your lifetime and you will leave at least $1 million to your children upon your death, then the trust should not be a generation-skipping trust. The trust can continue until your child reaches a certain age and then can terminate with the funds distributed to your child at that time. However, let's assume that these funds are not anticipated to be needed by your child. The trust can be structured as a generation-skipping trust to continue for your child's lifetime.

> You can create a generation-skipping trust of which your child and his/her children are the beneficiaries. Your child can be the trustee of this trust.

Now let's look at another extension of the use of this type of trust. Let's assume that you are married and that your child has two children. You are making gifts of $22,000 to your child each year. You do not make regular gifts to your grandchildren. In the past you may have given them some money in a custodial account to be used for their education, but the amount held in this account is now sufficient to pay for the grandchild's education, and you do not want your grandchild to have any more money until you have the opportunity to see how your grandchild is going to mature. However, you are not concerned about giving your child additional funds which he/she can distribute to your grandchildren if he/she so chooses.

You can create a generation-skipping trust of which your child and his/her children are the beneficiaries. Your child can be the trustee of this trust. By giving your grandchildren the right to withdraw their share of the contribution to the trust, you can make your $11,000 ($22,000 including your spouse) annual exclusion gifts to this trust. The funds are then available to your child if your child should need them. Your child could also make distributions to his/her children if he/she feels that is prudent. Your child can have the power to change the distribution of the trust to his/her children upon his/her death.

Fully utilizing your annual exclusion gift amounts is very advantageous. For example, assume you make an additional $40,000 gift to the trust each year. Over a twenty year period, this amount will grow to $2,882,098 assuming the funds are invested at 12%. Assuming your estate is taxed in the 50% bracket, making these annual exclusion gifts saves $1,441,049 in estate taxes. These gifts

> One very important caveat - you should file a gift tax return when the trust is created electing to have generation skipping exemption automatically allocated to all contributions to the trust.

only used $400,000 of your generation-skipping exemption and $400,000 of your spouse's generation-skipping exemption.

One very important caveat - you must either file a gift tax return each year allocating a portion of your $1 million generation-skipping exemption to this trust or you must file a gift tax return when the trust is created and elect to have the trust be treated as a trust to which generation skipping exemption is automatically allocated each year. If you have not allocated your generation skipping exemption and/or if generation skipping is not automatically allocated to the trust, then when you do allocate your exemption, the amount of the exemption allocated to the trust will be the value of the assets held in the trust at the time the gift tax return is filed making the allocation. In our above example, you would not have sufficient exemption remaining to make the trust exempt if you did not file a gift tax return until the end of the twenty year period.

> By structuring the generation-skipping trust so that the income is taxed to you individually, you will increase the amount retained in the trust.

In the section entitled "Defective Grantor Trust" I discuss the use of a trust created during your lifetime which is structured so that you are taxed on the income earned in the trust. I frequently use a generation-skipping trust as the trust which is structured in this manner. By structuring the generation-skipping trust so that the income is taxed to you individually, you will increase the amount retained in the trust. As discussed in the Defective Grantor Trust section, this trust can also be used to purchase assets from you on a long term note so that most of the appreciation in the asset is transferred to the trust tax free.

QPRT

A Qualified Personal Residence Trust is a trust which holds your home or vacation home for a period of years. At the end of that period of years, your home or vacation home passes to your children or a trust for your children. Giving away one's home is not something most people consider doing. For this reason, this trust is one which is rarely used unless some tax benefit is attached to doing so - and even then, it feels unnatural.

The Qualified Personal Residence Trust is a trust which you create to own your home for a period of years. At the end of the period of years the home passes to your children (or other beneficiary) or a trust for your children.

At the time you create the trust and transfer your home to the trust, you are deemed to have made a gift to your children. The value of the gift is reduced to reflect that your children do not have the use of the home for the period of the trust. The reduction in value is based on the current interest rate. For example, let's assume you are 50 years old, you create a trust for 10 years transferring

> You are able to transfer property (your home) to your children at a reduced tax cost.

your $500,000 home to the trust. Using the a federal rate of 7.2%, the amount of the gift to your children would be $228,000.

If you die during the term of the trust, the home is included in your estate and your estate is credited with the amount of the gift tax on the transfer of the home to the QPRT. If you survive the term of the trust, the home passes to your children with no additional tax.

Tax Benefits

You are able to transfer property, your home, to your children at a reduced tax cost. In the above example you give an asset valued at $500,000 paying a gift tax on $228,000 value. In the discussion below we will discuss ways to maximize the value transferred and minimize the size of the gift, to leverage the transfer so to speak.

Unnatural? Why?

It feels unnatural to most people from both a psychological perspective and from a financial perspective. Your home is your security, your place to come back to. Your place that is always there for you - your home base, your touchstone. If you have conflict with your children, want to feel independent of them, you come home. If you want to nurture your children, you have them come home for an evening, for a week, for a summer. The longer you have lived in your home, the stronger the feeling. If you give your home to your children, you change this

dynamic. They own your home. You go back to the home they own. The shift may be subtle but it is present nevertheless. This feeling seems to be stronger in women since I have found that more men are willing to use the QPRT

It feels unnatural to most people from both a psychological perspective and from a financial perspective.

than women.

Financially, purchasing a home and paying off the mortgage provides you with a place to live. If all other sources of income wither away, you have a home you can live in. If the home is valuable and all other investments go awry, the home can be sold and the proceeds invested for your security. Sometimes this concern is real. However, the "feeling" that one is giving up ones security, even though the perception is not accurate, creates a psychological impediment to using a QPRT. In addition, the idea that at the end of the term of the QPRT you will be living in a home your children own may be awkward. The idea of paying rent to your children may also be distasteful - even though paying rent is a good "wealth transfer" idea.

You can take a mid-ground position to minimize those feelings and transfer only part of your home to the QPRT. Transferring only a portion of your home is actually more advantageous, but I will discuss that benefit later.

Let's look at the "irreversibility" of the QPRT. What if you *do* need the money.

Let's say you had a business, oil and gas interests and real estate (highly leveraged but also highly appreciating) valued at $3 million and a home valued at $500,000. You are 55 years old and create a 15 year QPRT. Over the next 10 years, the business goes under, the oil and gas dries up and the real estate declines slightly and is ultimately foreclosed on. However, the residential area where your home is located has boomed and your home is now worth $1.5 million, and you need the funds the sale of your house would bring. Can you get them? Yes, *if you planned for that option in advance*. If you sell the home during the term of the QPRT and do not buy another house, you must either convert the trust into a Grantor Retained Annuity Trust (discussed below) or distribute the funds to the Grantor, i.e. you. If the Trustee does distribute the proceeds from the sale

...paying rent is a good "wealth transfer" idea.

of your home to you, you will have lost the portion of your exemption used on the initial gift, but your estate tax is not your concern, your retirement is. If you want to leave this option open to you, you cannot be the Trustee of your QPRT. Unless you want to retain this option, this option is not included and the grantor serves as the Trustee of the trust. With the increasing exemption amount, individuals with limited resources do not transfer any assets which they feel they might need in the future.

Now let's assume that the QPRT remains beneficial, but you want to sell your home and move to another home. What are your options?

You can sell your home and reinvest the proceeds in another home or you can convert the QPRT to a GRAT. Oh no, another acronym. the GRAT is a Grantor Retained Annuity Trust. The GRAT was created in the same law which eliminated GRITs except for House GRITs. The GRAT is a trust for a term of years which pays a fixed amount to the Grantor (the person who created the trust). At the end of the term, the trust is distributed to your children or other beneficiary (or a trust for your children/beneficiary). If a QPRT is converted to a GRAT, the proceeds from the sale of the house are invested and an annuity paid to the Grantor for the remaining term of the QPRT. For a more detailed discussion of a GRAT see the discussion below entitled "Grantor Retained Annuity Trust".

> If you sell the home during the term of the QPRT and do not buy another house, you must either convert the trust into a Grantor Retained Annuity Trust or, if you specifically provided for this option, distribute the funds to the Grantor, i.e. you.

So when you create a QPRT one of four scenarios may occur:

- Your home is transferred to the QPRT and you live in the home for the full term of the trust. At the end of the term your home is transferred to your children/beneficiaries or a trust for your children or other beneficiaries. At that time you will pay rent to them if you continue to live in the house.

- Your home is transferred to the QPRT. Later you sell your home and reinvest the proceeds in another home. You live in the new home for the term of the trust. If the cost of the replacement home is more than the home you sold, the QPRT will own part of the home. E.g. if the proceeds were $500,000 and the cost of the new home is $750,000, the QPRT will own 2/3 of the new home and you will own 1/3 outside of the QPRT.

- Your home is transferred to the QPRT. Later you sell your home and do not purchase a new home. The QPRT is converted to a GRAT and you receive an annuity from the trust for the remainder of the term after you sell the home.

- Your home is transferred to the QPRT. Later you sell your home. You are not the Trustee. You need the funds for your support and specifically provided that the funds may be returned to you. The Trustee distributes all of the proceeds from the sale of the home to you.

What about the property tax exemption? Your taxes may have been frozen at age 65. You also have the benefit of the homestead exemption. You continue to have the property tax exemption for your homestead and to have your property taxes frozen at the age 65 level during the term of the QPRT. After the QPRT terminates you lose this benefit. However, if you only transfer a portion of your home to the QPRT, then the property tax exemptions are retained even after the term of the QPRT.

What about the exemption from capital gains tax for the sale of a home? Again, the exemption is retained for the term of the QPRT. The exemption is also retained for any portion of the home which you do not transfer to the QPRT.

Increasing the Benefit of a QPRT

You can increase the benefit of the QPRT in a couple of different ways.

First, transfer only a fraction f your house to the QPRT. If the QPRT is beneficial, it seems that transferring only part of your house would be less beneficial, not more beneficial. The reason transferring part of your house is more beneficial is that an undivided interest in real estate is not valued at a proportionate amount of the entire value. The IRS admits that the value is reduced a small amount. However, they generally take the position that the reduction in value is in the 5% to 15% range. However, the cases which have been decided by the courts on the reduction in value due to an undivided interest generally hold that the reduction in value is from 20% to 25%. Some cases have held that the reduction is between 30% to 44%.

> You continue to have the property tax exemption for your homestead and to have your property taxes frozen at the age 65 level during the term of the QPRT.

Let's look at how this works in our $500,000 home example. If you keep the house and do not transfer it to a QPRT, you will have a $500,000 asset in your estate. If you transfer your home to a 10 year QPRT, you are taxed on $228,000. Now let's assume that you transfer 1/2 of your home to the QPRT. Using a 20% discount, a one-half interest in your home will be valued at $200,000. The remainder interest in property valued at $200,000, is $91,200. You still own a one-half interest which is also valued at $200,000. You have reduced your estate to $291,200 while still retaining one-half of the house. What if you transfer the remaining one-half of your house to another QPRT in a couple of years, you will further reduce the value of your estate.

> You can increase the benefit of the QPRT...transfer only part of your house to the QPRT....have the QPRT continue as a "grantor trust" after the initial term of the QPRT.

Second, have the QPRT continue as a "grantor trust" after the initial term of the QPRT. A grantor trust is a trust on which you are taxed on all of the income. The trust still provides that your children are the beneficiaries. The benefit of the trust being a "grantor trust" for income tax purposes is that the payment of rent to the trust will not be taxable. You cannot be taxed on income paid to yourself. The result is that the income is not taxed to

> If the psychological hurdles can be mounted, the tax benefits are worth it. Evidently a little too beneficial for the IRS.

you nor is it taxed to your children. No income tax, no transfer tax. Not bad.

If the gift is covered by your $1 million exemption, there is no loss of the use of the money which would have been used to pay the gift tax. For persons with larger

> The exemption from capital gains tax for the sale of a home? Retained for the term of the QPRT.

estates who have used their $1 million exemption for other gifts, the QPRT is most beneficial with a short term trust which continues as a grantor trust after the term to which rent can be paid.

If the psychological hurdles can be mounted, the tax benefits are worth it. Evidently a little too beneficial for the IRS. The IRS has requested in Clinton's 1998 budget proposal that the use of QPRTs be eliminated.

GRANTOR RETAINED ANNUITY TRUSTS

GRITS, GRATS, GRUTS: SOUTHERN FOODS, GUTTERAL EXPRESSIONS ... OR WHAT? I am enamored with GRATs. If the situation fits -- the GRAT can transfer literally millions of dollars tax free to your children. The GRAT is a trust which transfers all of the appreciation in an asset over the current interest rate to ones children (or other beneficiaries) tax free.

Let's start at the beginning and look at what this acronym stands for and how it works. GRAT is an acronym for a Grantor Retained Annuity Trust. A GRAT is a trust from which the Grantor receives a fixed dollar amount each year for the term of the trust.

the GRAT can transfer literally millions of dollars tax free to your children.

In a GRAT the Grantor creates a trust and provides that the trust will pay him a fixed dollar amount each year for the term of the trust. The fixed dollar amount paid to the Grantor each year is called an annuity. The annuity is set at a percentage of the value of the assets held in the trust. For example, if you transfer $1 million to the trust and provide that you will receive a 8% annuity, the trust will pay you $80,000 per year. You pick the term, you pick the annuity, you pick the property to go into the trust.

Who are the players in a GRAT? Let's assume you are creating a GRAT and transferring $1 million to the GRAT. You are the Grantor of the GRAT. You can also be the Trustee of the GRAT. You are also the only beneficiary of the GRAT for as long as the GRAT lasts. At the end of the term of the GRAT, the trust terminates and the property passes to anyone you designate, e.g. your children. You would be the present beneficiary and your children would be the remainder beneficiaries.

So what is the benefit of the GRAT? When you create a GRAT you have made a gift to your children of the value of receiving the property at the end of the term of the trust. The gift is valued according to actuarial tables using the current federal income tax rate. The amount of the gift may be much less or

In a GRAT, the Grantor creates a trust and provides that the trust will pay him a fixed dollar amount each year for the term of the trust.

much more than is actually transferred to your remainder beneficiaries. Your objective is to actually transfer more than the IRS table show that you would transfer.

You pick the term, you pick the annuity, you pick the property to go into the trust.

The amount that the IRS determines is a gift is dependent on several factors. First, the term of the GRAT (how long the GRAT continues to pay the annuity to the Grantor). Second, the amount of the annuity paid to the Grantor. Third, the current interest rate is. An actuarial computation is made based on the interest rate in the month the GRAT is created to determine the value of the remainder interest at the end of the term of the GRAT. This amount is a gift at the time the GRAT is created. The government sets a new interest rate each month. For example in March, 1997 the interest rate to be used was 7.8% and in July, 2003 the interest rate to be used was 3.0%. The value of the annuity payments is determined and subtracted from the value of the property transferred to the GRAT to determine the value of the gift.

If you are older, then the likelihood that you will die during the term decreases the value of your income interest and increases the value of the gift. Let's look at some examples. If the current interest rate is 8% and at age 50 you set up a 20 year GRAT funding it with $1 million, paying yourself an 8% annuity of $80,000 one time a year, the value of the gift to your children is $269,360. You will report this as a gift and pay the tax on the gift upon the creation of the trust. If the property you transfer to the trust retains its value and yields an income of 8% your children will receive $1 million in 20 years with no additional tax owed at that time. If the property also increased in value at 2% per year, your children would receive property valued at almost $1.5 million in 20 years. The GRAT enables you to transfer the return on property in excess of the current interest rate gift tax free.

You can also be the Trustee of the GRAT.

What if you die during the term? The property which is held in the trust at the time of your death is included in your estate and your gift tax is credited against your estate tax. In other words, no win, no lose --- except the loss of the use of the money paid in gift tax.

First rule: set the term for a period which is less than your life expectancy.

The following chart shows the difference in the amount of the gift when $1 million is transferred to a GRAT when some of the variables in the GRAT are changed.

A GRAT enables you to transfer all appreciation over the current interest rate at no transfer tax.

Term	Annuity	Gift
10	8%	$ 480,440
10	15%	$ 25,825
15	8%	$ 349,832
15	12%	$ 24,748
20	8%	$ 269,360
20	10%	$ 86,700

The IRS assumes that your property will yield a return equal to the current interest

..... the first rule is: set the term for a period which is less than your life expectancy.

rate. If the property does yield an amount equal to the interest rate at the time the GRAT is created, then you have given your children exactly what the charts reflect you would and on which you paid a gift tax. If your property has a return rate greater than the current interest rate, then you transfer more to your children (or other beneficiaries) than the amount on which you paid a tax.

Second rule: only create a GRAT if your property has a return rate greater than the current interest rate. Actually your children will receive slightly less than that amount since the gift is increased by the likelihood that you will die during the term.

Now let's assume that your property has a return equal to 12% per year. 12% is the return on the stock market over a 20 year period. If you create a GRAT for a term of 20 years funding the GRAT with assets valued at $1 million, the value passing to children in 20 years is shown in the following chart assuming an annuity of 8% and an annuity of 10%. Either of the GRATs transfer a significant amount of property to your children tax free.

Annuity on $1 Million	Annuity	Gift	Value passing to children in 20 years
8%	$ 80,000	$ 269,360	$ 2,191,123
10%	$100,000	$ 86,700	$ 1,485,947

What if the property declines in value? If the property declines in value, then more of the property will be returned to you and less property will be distributed to your children. If the property declines in value then you will have paid a gift tax on property your children never received.

Second rule - only create a GRAT if your property has a return greater than the current interest rate.

Third rule: Set the annuity and term so that the gift to your children is determined to be close to zero.

Now you have the basics, let's look at some situations in which the GRAT can transfer literally millions to your children at a nominal gift tax cost.

Scenario #1 - Highly appreciating property

Let's assume you have some property which has a return of 20% or greater which is relatively stable. This asset could be the interest in a business, stocks or real estate. One example may be a piece of commercial real estate valued at $2 million. The real estate generates $300,000 per year in net revenue and is appreciating at about 5% per year. Assuming a current interest rate of 8%, you could transfer the property to a 10 year GRAT with an annuity of 15%. Assuming you are 50 years old, the gift would be valued at $25,825. The $300,000 would be paid to you each year. At the end of the 10 year period, your children would receive the property valued at that time at $4,886,684 with no additional tax cost. In this situation for about $14,200 in tax you have transferred $4,886,684 to your children. In actual practice, the annuity amount is set so that

the third rule - set the annuity and term so that the gift to your children is determined to be relatively small.

the value of the gift is zero or a very small amount, such as $1,000.

Scenario #2 - Likely jump in the value of the stock

Let's assume you have a business valued at $4,000,000 that is seeking to obtain a contract for a new business venture. If the contract is obtained, the value of the business will increase two to three fold in the next two years. If the contract is obtained, you would like to transfer 1/4 - ½ of the stock to your children. Since all of the appreciation would occur in the next two years, you have elected to create a short term GRAT. Let's assume the entire amount of the appreciation occurs in the first year prior to the payment of the first year's annuity and no appreciation occurs after that time. Let's assume that 45% of the stock is transferred to the GRAT. For purposes of this illustration, no discounts are taken for minority interest or lack of marketability, thus the stock which is transferred to the GRAT is valued at $1.8 million. The GRAT continues for 5 years and the annuity is set at 25% with the following result. The annuity will be set at $450,000 per year. If no dividends are paid on the stock, a portion of the stock will have to be transferred each year to the Grantor to pay the annuity. The value of the gift for gift tax purposes will be $17,000. If the stock has large dividends or is an S corporation with sufficient cash flow to pay the annuity, then the fact that the stock will be discounted significantly increases the benefits derived from this trust.

If the stock doubles in value the stock remaining in the GRAT at the end of the five year term will be valued at $1,350,000. If the annuity is paid with stock each year, the GRAT will own about 16.875% of the stock of the company and the Grantor will own the remaining 83.125% of the stock of the company. If the stock triples in value the stock remaining in the GRAT will be valued at $3,150,000. In this situation, the GRAT will own about 39% of the stock in the company and the Grantor will own about 61% of the stock of the company.

> In this situation for about $14,200 in tax you have transferred $4,886,684 to your children.

> In this situation you have transferred $1,350,000 to $3,150,000 to your children for a cost of about $9,000 in tax.

Scenario #3 - Investment of high risk/high return

As a part of your investment portfolio you invest in high risk, high return stocks. Some of these stocks are invested in emerging markets, some in small caps and some in foreign stocks. The fluctuations on these markets can be dramatic so if the term of the trust is 10 years it will hit some upswings and some downswings in the market. Some of these high risk stocks will go up while others go down. To avoid losing the benefit of an upswing which is followed by a downswing in a market, the trust term is set for a short period, e.g. two years.

To prevent losing the benefit of an upswing in one group of stocks from a downturn in another stock, each group of stocks is held by a separate trust. You create three two year GRATs and transfer each of your portfolios, e.g. emerging markets, small caps and foreign stocks into a separate GRAT. You own $5 million of stock in each portfolio. Assuming the following returns, each GRAT transfers the following value to your children at the end of the two year term.

Asset	Value	Return	Gift	Value at end of term passing to children
stock portfolio A	$5M	40%/yr	$25,015	$3,700,000
stock portfolio B	$5M	20%/yr	$25,015	$1,150,000
stock portfolio C	$5M	5%/yr	$25,015	$0

If you create new trusts every two years when these trusts terminate, your GRATs are referred to as "rolling GRATs".

You probably will not be surprised that the IRS does not like GRATs. The structure of the GRAT is set forth in the statute, so these trusts are not something that is someone's idea - waiting to be tested. The IRS took note when they realized that literally millions of dollars have been and are being transferred without transfer tax using GRATs. The IRS is particularly concerned about the use of short term GRATs with "high payout", in other words, the GRATs which are designed to last a short period of time, have a large annuity which results in a nominal gift. Why? Because they do transfer large amounts tax free, with little risk of a volatile market and little risk of the Grantor dying during the term.

GRATs are a very safe way to transfer highly appreciating property since a redetermination of the value of an asset transferred does not result in a large gift. For example, let's say an interest in a closely held business was valued at $1 million. On audit, the fair market value is determined to be $2 million. By doubling the amount of the gift, the gift may be increased from $1,000 to $2,000. The main impact is that the annuity paid to the grantor is doubled, thus making the GRAT less effective at transferring property to the remainder beneficiaries but does not risk having the grantor owe a large gift tax.

DEFECTIVE GRANTOR TRUST

The distinguishing characteristic of a defective grantor trust is that the income in the trust is taxed to the grantor, the person who created the trust. A defective grantor trust can be any type of trust. The defective grantor trust can have any term and have any beneficiary. One benefit of using a defective grantor trust is to avoid the high income tax rates applicable to trusts. In addition, by paying the income tax on the income earned in the trust, all of the income is preserved in the trust for distribution to the grantor's family. The trust got its name when trusts were being used as income tax savings devices and structuring a trust in a manner which caused the income to be taxed to the grantor was a mistake, a defect.

All bad things are good if you just look at them in a different light. Historically, frequently trusts were created to save income taxes. Income tax rates have been as high as 90% for the top brackets. A trust had the same income tax rate structure as a married person filing separately. By creating a trust and transferring high income assets to the trust, you could ride up a whole new set of tax brackets. The benefit of having another tax bracket was dramatic. To prevent individuals from shifting income to a trust, a set of rules were developed which would cause the income earned on assets held in a trust to be taxed to the grantor, the person who created the trust. When the purpose of the trust was to shift income, if these rules were triggered, the purpose of creating the trust was defeated. A trust which violated one of these rules was "defective".

> A defective grantor trust is a trust which is structured so that the grantor is taxed on all of the income earned in the trust.

The top income tax bracket is now 35%, thereby minimizing the benefit of shifting income to a trust. Even more importantly, the income tax rate structure for trusts has been changed. Trusts reach the top income tax bracket at under $10,000 ($9,250 in 2003 adjusted annually for inflation). The maximum benefit which can be derived from shifting income to a trust is minimal. In general however, you don't want to be taxed on income that you don't receive. True, but everything can be looked at differently. In the situation with a "defective grantor trust", the trust can be looked at in two different ways.

Let's assume you create a trust for the benefit of your children. You would like to transfer as much to this trust as possible. The more you transfer to the trust, the less your estate tax will be. If you pay the tax on the income in the trust, the trust will not be reduced by the payment of the income taxes. More property is preserved

> All bad things are good if you just look at them in a different light.

in the trust for distribution to your children or other beneficiaries.

For example, let's assume you have transferred $500,000 to a trust for the benefit of your children and grandchildren. Let's also assume that the income earned in that trust is $40,000, all taxable income. If the trust pays the tax on the income, about $14,000 will be paid in income tax leaving assets valued at $526,000 in the trust at the end of the year. If the grantor pays the tax on the income, then the trust will have $540,000 in assets at the end of the year. Payment of the income taxes has the same effect as an additional contribution to the trust. In fact, the IRS has tried to argue that it is an additional gift to the trust. However, since the payment of the tax is required by the IRS, it cannot be deemed to be a voluntary transfer of money. The IRS has backed off this position.

> Trusts reach the top income tax bracket at under $10,000.

Another benefit of the grantor trust is that there is no tax on a transaction with the grantor. For example, let's assume that the trust leases property to the grantor. The grantor cannot deduct lease payments made to himself, nor can he be taxed on lease payments made to himself. If the grantor sells property to the trust, no gain is recognized. If the trust later sells the property, the grantor will recognize a gain on the sale at that time. The trust will have the same basis as the grantor for purposes of determining the amount of gain.

Any trust which is created can be structured to be a defective grantor trust. The technique which has been used recently is to sell property with a high appreciation potential to a defective grantor trust. The sale can be made by giving the grantor an installment note. In July, 2003, the interest rates reached an all time low, with the rate required to be charged on a three to nine year note with interest payable annually is 2.55% The result of the technique is to transfer all of the appreciation in the asset over the interest on the note to the trust free of transfer tax.

Some advisors feel this technique is one of the most beneficial estate planning techniques available. The effect of the installment sale to a defective grantor trust is similar to the effect of a Grantor Retained Annuity Trust (GRAT). The GRAT was discussed earlier. The GRAT pays the grantor an annuity for a term of years. The term of the GRAT is similar to the term of the note. The annuity paid to the grantor is similar to the installment payment on the note. A GRAT is a defective grantor trust. All of the income on the assets held in a GRAT is taxed to the grantor.

> If you pay the tax on the income in the trust, more property is preserved in the trust for distribution to your children (or other beneficiaries.)

What's the difference? What are the advantages of one over the other? The interest rate applied in determining the amount of the annuity is higher than the interest rate required to be paid on the installment note. The note can continue

beyond the grantor's lifetime and the assets will not be included in the grantor's estate. These two differences favor the use of an installment sale to a defective grantor trust.

There are also two differences which favor GRATs over installment sales to defective grantor trusts. First, the impact of a redetermination of the value of the asset sold to the defective grantor trust results in the grantor making a gift to the trust of the difference between the value of the asset and the amount of the note. Second, the defective grantor trust must have other assets. Most advisors are comfortable with assets equal to at least 10% of the amount of the note. This requirement is one of the disadvantages of the sale to a defective grantor trust. There is a downside. If the assets decrease in value, the benefits are lost. There are also some thorny income tax questions if the grantor dies while the note is outstanding. Bear with me for a technical tangent. Does the trust have the same basis as the grantor? If so, all of the payments made on the note did not give the trust any additional basis for determining gain. If the basis of the asset is the value on the date of death, the only way that could occur is if the grantor recognized gain on the sale at the time of his death.

> Sell property with a high appreciation potential to a defective grantor trust...Some advisors feel this technique is one of the most beneficial estate planning techniques available..

I mention these differences. They are problems. Sometimes they can be opportunities. The uncertainty of the income tax treatment of the note on the sale to a defective grantor trust is illustrative of a number of unclear areas in the tax law, and in the estate tax area in particular. Any technique which is beneficial will be analyzed by the IRS for possible arguments to reduce the benefits. If the technique becomes popular and gains a wider use, the IRS will redouble its efforts to minimize or eliminate the benefits. The use of family limited partnerships is a good example of an estate planning structure which has beneficial tax consequences which the IRS is seeking to curtail.

Like the Family Limited Partnership and the GRAT, the use of an installment sale to a defective grantor trust is another tool in the estate planner's toolbox.

CRUMMEY DEFECTIVE GRANTOR SPENDTHRIFT TRUST
or
"Have Your Cake and Eat It, Too" Trust

You will not find the "Have Your Cake and Eat It, Too Trust" in any text book, at least not by that name. Trusts derive their names from a variety of sources. Some derive their names from a section of the Internal Revenue Code, such as the 2503(c) Trust, or from the name given them in the Internal Revenue Code, such as the Qualified Terminable Interest Property Trust (QTIP Trust). The Bypass Trust derives its name from its use in an estate plan since the assets in the Bypass Trust bypass taxation in the surviving spouse's estate. I used the longer, more boring name of the "Crummey Defective Grantor Spendthrift Trust" to provide it with a name descriptive of some of its components. The "Have Your Cake and Eat It, Too Trust" ("Cake Trust" for short) is a trust which I use in estate planning which provides the benefit of the use of assets and exclusion from our taxable estate. Ideally, we would like to own all of our assets in a form in which we could use them if needed, but in a form in which the assets would not be included in our taxable estate and would not be subject to the claims of creditors and estranged spouses. The "cake trust" provides these benefits.

The Cake Trust has elements of other trusts which are discussed in other sections of the Guidebook. Think of the trust as a recipe which has variations which we may use in certain situations. The Cake Trust draws from a number of different areas to gain its many benefits. Our goal is to have no negative consequences and no gift or estate tax consequences for you or the person creating the trust, as well as gaining the protection benefits mentioned. We also want to avoid income taxation at the trust rates. Trusts reach the top income tax bracket under $10,000. To gain these benefits, we will draw on a number of different tax and trust laws. As you might have guessed, that means you are about to hear a litany of technical areas to gain the benefits. As you read, you will be inclined to toss this section, but hold on! You will be impressed with the uses of the trust.

Ideally, we would like to own all of our assets in a form in which we could use them if needed but in a form in which the assets would not be included in our taxable estate and would not be subject to the claims of creditors and estranged spouses.

The "cake trust" provides these benefits.

First, let's look at the elements of the trust and then see ways we can use them in estate planning.

The Trust is Created by Someone Other than You

The Trust is created by someone else, e.g. your parents, for your benefit. This element is essential. You cannot gain the benefits of estate tax avoidance, creditor protection and estranged spouse protection in a trust which you create for your own benefit. The creator of the trust is called the grantor. Any person who makes a contribution to the trust will be considered the grantor of the trust as to that contribution. We will come back to this aspect a couple more times in our discussion. At this time, the significance of not making any of the contributions is that you cannot have your parents sign the trust document and then you put the money in the trust yourself. For tax purposes you will be treated as the grantor of those contributions.

You are the Trustee of the Trust

You are the trustee of the trust. Although generally you would want to be your own trustee, your parents (or another person who created the trust) could name someone else as the trustee and you would still retain the benefit of estate tax exclusion, creditor protection and estranged spouse protection. However, you would not control the investment of the assets or control the distribution of the income and principal from the trust. If you are the trustee and the beneficiary, as I would normally structure the trust, then as trustee your power to distribute income and principal of the trust would be limited so that income and principal could only be distributed for your health, education, support and maintenance according to your station in life. Are these special terms? Yes. The IRS has held that if your ability to distribute the assets in a trust is limited by an ascertainable standard, then the assets are not included in your estate. The IRS has held that health, education, support and maintenance provides an ascertainable standard. An ascertainable standard is one which for which a court would be able to determine the amount to be distributed and could enforce the standard. A trust could not give you the power to distribute the income and principal for your "comfort," because that term is considered too subjective to be ascertainable since only you know what you need for your comfort. Use of that term would cause the assets to be included in your estate if you are the trustee.

You are the Trustee and the Beneficiary of the Trust.

You are the Sole Beneficiary of the Trust

You are the sole beneficiary of the trust. To gain the benefits of the trust it is not essential that you be the *only* beneficiary. However, if the trust includes other beneficiaries, then the trustee will need to consider their needs in making distributions from the trust.

You are given a Crummy Withdrawal Power

You are given the power to withdraw all contributions made to the trust. Giving you the right to withdraw all contributions results in the contributions to the trust qualifying for the $11,000 annual exclusion from gift tax. Having the “withdrawal” right is what causes the trust to be called a “Crummey Trust” since Mr. Crummey is the taxpayer who used this withdrawal right for minors, was challenged by the IRS and won. If all contributions are subject to your power to withdraw the assets contributed, then you are taxed on all of the income received by the trust. A defective grantor trust is a trust on which the grantor is taxed on all of the income. This trust is structured as a “Crummey defective grantor trust” so that all of the income is taxed to the beneficiary of the trust holding the withdrawal power.

All of the income is taxed to the beneficiary of the trust.

Your Right to Withdraw Lapses $5,000 Per Year

If the gifts to the trust exceed $5,000 (or 5% of the trust assets) then we want your power to withdraw these amounts to continue so that your withdrawal right lapses at no greater than $5,000 (or 5% of the trust assets) each year. If the contributions exceed this amount and your withdrawal right lapses at a rate that is greater than the greater of $5,000 or 5% of the trust assets each year, the excess will be considered a contribution by you to the trust. As mentioned above, if you create a trust like this for yourself, then the benefits of estate tax exclusion, creditor protection and estranged spouse protection are lost. Also as I mentioned, if you make a contribution to the trust, you are treated as if you were the grantor of the trust as to that amount.

You Have the Power to Direct Distributions on Your Death

In our quest to give you as much power over the trust as possible, you are given a broad “special testamentary power of appointment,” which is the right to direct who receives the property on your death. The only limit to this power is that you cannot give the property to your creditors, your estate or creditors of your estate. If you have the power to give the property to any of these persons or entities, then the trust assets are included in your estate for tax purposes and protection benefits are also lost, thereby eliminating the benefits the trust is designed to gain. This power allows you to give the trust to virtually anyone else in the world, thus this restriction does not impair your ability to benefit the people (or charities) that you want to benefit. The trust will name the persons who will receive the property in the event that you fail to name alternate beneficiaries. One benefit from having this power is that the persons named cannot claim that you are “spending their inheritance” since their beneficial interest in the trust is dependent on your not exercising your power of appointment.

In our quest to give you as much power over the trust as possible, you are given the right to direct who receives the property on your death.

So what, you say?

A great trust? You agree, absolutely - but limited, you say, oh, so limited. You

realize that at the rate of $5,000 per year or even $11,000 or even $22,000 per year, you cannot accumulate much money in this trust. And, even more importantly, your parents (or whoever the wonderful person was who created this trust for you) only is willing to contribute $5,000 *total* to the trust - not even $5,000 per year. So what's the big deal here? Leverage, my friend, leverage. Now for the fun stuff!

How about a New Business

Let's say you have a new business you want to start. In Texas, I generally recommend that new businesses use the limited partnership structure. Limited partnerships are not subject to the franchise tax. In addition, limited partnerships are flow-through entities, meaning that the partnership is not a separate taxable entity, the income is taxed to the individual partners. This type of structure is more flexible in estate planning. A limited partnership has two types of partners, one or more general partners and one or more limited partners. You will be the general partner owning a 1% interest and your "Cake Trust" will be the limited partner owning 99% of the partnership. If the partnership needs more than the $5,000 held in the trust, as it probably will, you will loan those funds to the partnership. If you want to gain limited liability, then you will form a single member limited liability company of which you own 100% to be the general partner . If the business is a success, which we hope it is, then the trust owns 99% of the business. This 99% is out of your taxable estate and cannot be reached by creditors or estranged spouses. Keep in mind that you are the trustee and the beneficiary of this trust, so that you can control the assets, invest any distributions from the partnership and/or distribute them to yourself for your health, education, support and maintenance according to your station in life. Now that is having your cake and eating it too. It is better than outright ownership, since the IRS, your creditors and estranged spouses have rights to receive property you own outright. You are beginning to see the benefits, but ... you already have a business. How about a new division? A new store? A new product?

Have the trust own a new business or division.

Or a New Division

If you have an existing business but will expand the business into new territories, new products or new stores, then form a limited partnership to own the new territory, new product or new store. Your existing business can be the general partner of the limited partnership and your Cake Trust can be the limited partner. Additional capital needed can be loaned by the existing business to the new limited partnership. No new territory, product or store - just good cash flow, well that'll work ....

Use Cash Flow of Business to Purchase an Interest in It

Your business is established, it is not expanding, but it does have wonderful profits and cash flow. If your business distributes its cash flow as dividends of an S corporation or as profits to its limited partners, then have the trust buy it. Sound strange? Let's look how it works. Let's use some numbers to make the explanation a little easier to follow. Let's

assume that your business is valued at $1 million. It generates profits of $100,000 per year. If you sell less than 50% of the business to the Cake Trust, the interest will be discounted for lack of marketability and minority interest. The discounts for minority interests in closely held businesses are often 40% or more, so let's assume a 40% discount. Your Cake Trust purchases 40% of the business. 40% of $1 million is $400,000 less a 40% discount leaves a value of $240,000. Your Cake Trust purchases the business on a nine-year interest-only balloon note. The note could be amortized and it could be for a term greater than 9 years. An interest-only balloon note gives you the flexibility to make smaller payments on the note if the cash flow in the business decreases. The interest rate required to be charged on a note fluctuates monthly according to the applicable federal rate. A mid-term note is a note whose term is greater than 3 years and not more than 9 years. Generally the mid-term rates are lower than the long-term rates. In July, 2003, the mid term rate reached an all time low of 2.55% for notes with interest payable annually. For illustration purposes, let's assume that the rate is 6%. The interest which will be owed each year will be $14,200 per year. The trust will receive its 40% of the profits. If the profits continue at the same rate, the trust will receive $40,000 per year of profits. Since you will be taxed on the income received by the trust, the trust will be able to use the full $40,000 to repay the note to you in purchase of the interest in your business. Nice idea, but .... you have a zero basis in the business and you do not want to realize a $240,000 gain on the sale. No problem! You cannot be taxed on a gain on a sale of an asset to yourself. Since you are taxed on all of the income in the trust, for tax purposes you will be treated as selling the asset to yourself, so there will be no gain on the sale. The trust will have the same basis you had in the interest in the business; in our hypothetical, the basis is zero.

> If your business distributes its cash flow as dividends of an S corporation or as profits to its limited partners, then have the trust buy the business.

Are there any caveats in this transaction, any catches? Yes. Since you will lose the benefits of this trust if you make a contribution to this trust, it is very important that your Cake Trust pay the fair market value for its 40% interest. Considering the importance of retaining all benefits of this trust, you should obtain an appraisal of the 40% interest in the business to be sold to the trust. During the time when the business interest is being purchased by the trust, it is possible that the IRS may argue that your interest in the business has been "retained" and thus will include the interest in your estate upon your death. Proper planning can minimize this risk. By the way, if your profits remain at the $100,000 level, your Cake Trust will have fully purchased its 40% interest in the business in 7-8 years. No business interest? Then do you .....

Have a Good Cash Flow Asset?

Any asset which generates a good cash flow can be sold to your trust. For example, if you have rental real estate, you can sell part of that interest. Rental real estate which is owned in a limited partnership is generally discounted about 40%. If the property is not held in a limited partnership, an undivided interest in real estate is also discounted, but the discount is somewhat less. Courts have

discounted undivided interests in real estate from 10% -44%. Let's review the impact of a sale of a 40% interest in a $1 million real estate project generating 10% return cash flow. If the interest is discounted 20%, then the 40% interest would be purchased for $320,000. The interest on this note would be $19,200, assuming a 6% interest rate. The $40,000 of profits distributed to the trust is sufficient to pay the interest on the note and to reduce the principal annually. The note will be paid in about 10 years if all of the cash flow is used to reduce the principal on the note.

> Any asset which generates a good cash flow can be sold to your trust.

All of the income received by the trust will be taxed to you and as with the sale of an interest in the business, no gain is realized on the sale since you will be treated as having sold an asset to yourself. Again, as with the sale of the business interest, proper valuation of the interest is very important to avoid you being treated as making a contribution to the trust.

Now - control, benefits, protection from taxes, creditors and estranged spouses and a little leverage - that is having your cake and eating it too, wouldn't you say?

CHARITABLE REMAINDER TRUSTS

A Charitable Remainder Trust can provide significant benefits for the person who creates it while benefitting charity later. Although the IRS has recently put some additional restrictions on the trusts, the trusts still provide significant benefits in certain situations. The most advantageous situation is for an individual who has a highly appreciated asset and has a life expectancy of at least 20 years. But I'm getting ahead of myself. Let's look at the kinds of charitable remainder trusts, the flexibility we have in structuring them and their treatment from a tax perspective to give us a framework for assessing their benefits.

All charitable remainder trusts (CRTs) provide for payments to an individual during the term of the trust with the remainder passing to a charity upon the end of the term. The term of the CRT can be for the life of an individual or can be for a term of years not to exceed 20 years or a combination of both. If the life of an individual is combined with a term of years, the term must begin at the time the trust is created and may not begin at the time one of the individual life recipients dies.

The most advantageous situation is for an individual who has a highly appreciated asset and has a life expectancy of at least 20 years.

The individual who receives the payments during the term can be the grantor (the person who created the trust) or another person. If the individual is another person then the grantor will be considered have made a gift to the individual who is to receive the payments during the term of the trust. The amount of the gift to the individual will be the actuarial value of the payments to be received by the individual.

The grantor receives a charitable income tax deduction at the time the trust is created for the actuarial value of the remainder which passes to charity.

Most trusts name the grantor or the grantor and his spouse as the recipient beneficiaries for the term of the trust. For simplicity I will assume that the grantor is also the recipient of the payments.

The grantor receives an income tax charitable deduction at the time the trust is created for the actuarial value of the remainder which passes to charity. The actuarial value of the amount passing to charity must be at least 10% of the value of the assets originally contributed to the trust. The charitable deduction is limited to 50% of the grantor's income if the remainder charity is a public charity and to 30% of the grantor's income if the remainder charity is (or can be) a private foundation. The grantor can retain the right to change the charity receiving the remainder interest of the trust.

The trust is a tax exempt entity. Therefore, if you transfer low basis

property to the trust and the property is sold, no tax will be owed by the trust. The payments made to the recipient during the term "carry out" the income in the trust over the life of the trust.

> If you transfer low basis property to the trust and the property is sold, no tax will be owed by the trust.

For example, if the trust has $50,000 of income and the payment to the recipient is $50,000, the recipient will report all of the income as ordinary income. What if the trust did not have any income in the year of the payment? If the trust did not have any income in the year of the payment, the trust will be deemed to have distributed any income from prior years which was not distributed. For example, let's assume that in the first year of the trust, the trust had $60,000 in ordinary income and none in the second year. The trust had no other income. The first year the trust distributed $50,000 to the recipient and distributed another $50,000 to the recipient in the second year. The recipient would report $50,000 ordinary income in the first year and $10,000 ordinary income in the second year. In actuality, a non-taxable situation rarely occurs. Usually low basis property is transferred to the trust and is later sold with a large capital gain. After all ordinary income has been distributed to the recipient, the recipient will be deemed to have received capital gain until all the capital gains have been distributed.

Charitable Remainder Trusts come in two main types: charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). A charitable remainder annuity trust provides that the annual payment will be a fixed amount equal to a percentage of the value of the assets contributed to the trust. The percentage must be equal to or greater than 5%. For example, a charitable remainder annuity trust which is initially funded with $1 million and provides for a 5% annuity payment will pay $50,000 each year to the annuity recipient. The amount of the annuity (e.g. $50,000) will remain the same for the entire term of the trust.

> Charitable Remainder Trusts come in two main types: charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs).

A charitable remainder unitrust provides that the annual payment will be a fixed percentage of the value of the assets held in the trust redetermined annually. For example, a charitable remainder trust which is initially funded with $1 million and provides for a 5% unitrust payment will pay $50,000 to the unitrust recipient in the first year. The amount paid to the unitrust recipient in the second year will depend on the value of the assets. Let's assume that the value of the trust assets have increased to $1,050,000. The unitrust payment in the second year will be $52,500. If the value of the trust assets have decreased to $950,000, then the unitrust payment in the second year will be $47,500. Which is better? If the value of the assets are likely to decline, then the annuity trust will pay more to the annuity recipient over the term of the trust. If the value of the assets are likely to increase, then the unitrust will pay more to the unitrust recipient over the term of the trust.

Our parameters in designing the trust are that the trust can be created for a term not to exceed 20 years or the life of a beneficiary, the payment may not be less than 5% per year, and the value of the remainder interest passing to charity cannot be less than 10% of the value of the remainder. Let's assume that you want to maximize the benefits that will be paid back to you. The value of the remainder depends on the current applicable federal rate. The higher the rate, the larger the remainder for an annuity trust but the applicable federal rate has very little impact on a unitrust. Let's look at some examples of the maximum payout you can have for a different trusts assuming an AFR of 7%:

Annuity Trust

Age of Recipient	(at 7% AFR) Maximum % payout	(at 9% AFR) Maximum % payout
30	6.78	8.46
40	7.14	8.77
50	7.32	9.17
60	7.67	9.42
70	8.34	9.97
20 year term	8.49	9.85

Unitrust

Age of Recipient	Maximum % payout**
30	5.52
40	7.18
50	10.21
60	16.01
70	27.05
20 year term	10.87

** A unitrust payout is not affected by the current applicable federal rate.

Ok, enough of this dry discussion - how do they really work and when would you want to use them? First, consider them when you have a charity that you would like to benefit on your death. If you would like to give a charity a certain asset, then you can transfer the asset to a trust, retaining a stream of annuity or unitrust payments for your lifetime with the charity receiving the asset upon your death. There are situations in which you will actually receive more money if you create a CRT than if you retained the property and held it outside of a trust. Your ears perk up. What are these situations?

> If you have a zero basis or a very low basis in the property and you have a life expectancy of at least 20 years, then <u>you</u> will actually receive more money if you transfer the property to the CRT than if you retain the property.

In general, these situations are ones in which you have a zero basis or a very low basis in the property and you have a life expectancy of at least 20 years. If you are 60 years of age or younger you have a life expectancy of about 20 years. If you are married and you want to include your spouse as a beneficiary and have the trust continue until the last of you and your spouse to die, then you and your spouse have a combined life expectancy of at least 20 years if you are both 67 years of age or younger.

Let's assume a zero basis in the asset and compare the use of an 8% CRUT to selling the asset, paying the capital gains and investing the remaining funds at 12% (9.6% net assuming all

capital gains). We will assume that each annuity payment is received and reinvested at the same hypothetical 12% (9.6% after tax). The point at which the annuity recipient would have received more money having used the trust than if he did not is between 17-18 years. After the 17-18 year period you not only would have received more money than if you had not created any trust, but the charity of your choice will also receive a significant benefit. These benefits are even more significant to the individual when the charity is a private foundation. OK, let's say you like the idea. However, you want to ensure that you receive the benefits for at least the 17-18 years. You name your spouse but you want to provide that the trust will have a minimum term of 20 years, with your children as beneficiaries for the remainder of the 20-year term if both you and your spouse die. Sounds like a good plan, but there's a catch. Upon your death, the interest for your spouse will qualify for the marital deduction *only if* there are no other non-charitable beneficiaries. If both you and your spouse die within the 20 year period, there could be a significant tax upon your death if your spouse survives you. Let's use an example. Assume that you and your spouse are each 56 years old. You contribute $1 million to the trust and set the annuity at 8%. Your trust provides a return of 12% as you had hoped. The trust is paying out 8%, so the trust is increasing by 4% per year. At the end of 10 years, the trust has a value of $1.4 million. If you died in that year, the value of the interest to be received by your spouse would be $966,000. This interest would *not* qualify as a gift to your spouse if another person (in this case, your children) *could* receive the benefits from the trust. Therefore, the $966,000 would be taxable.

The point at which the annuity recipient would have received more money having used the trust than if he did not is between 17-18 years.

It is much better to purchase insurance on the life of you and your spouse than to include your children as possible beneficiaries of the charitable remainder trust.

Since you actually have more money than if the trust had not been created in 17-18 years, the disadvantage to your children occurs in the event of a premature death. To protect against this possible situation, it is much better to purchase insurance on the life of you and your spouse than to include your children as possible beneficiaries of the charitable remainder trust. The insurance should be owned by a trust to keep the insurance proceeds from being taxable in your estate.

The main benefits for the person creating the trust are the charitable income tax deduction and the tax exempt status of the trust. Of these two benefits, the tax exempt status of the trust is the more significant benefit. The charitable income tax deduction is limited to the value of the remainder interest. The charitable remainder interest is required to be at least 10% and is usually set at exactly 10%. The deduction for a $1 million gift would be $100,000 and assuming the donor is in the 35% bracket would save the donor $35,000. If the asset had a zero basis and was sold, the savings in capital gains tax on that sale alone would be $200,000. The accumulation of the gain inside the trust is tax free.

You have some property that yields no income. You can create a NIMCRUT - a net income make-up charitable remainder unitrust.

Now let's assume that you have some property that yields no income. For example, let's assume that you have a piece of raw land or stock which does not pay a dividend. You do not want to force a sale of the asset in order to make the annual payments, nor do you want the trust to distribute part of the land or stock back to you in payment of the annual payment. Do you have another option? Yes, you can create a NIMCRUT - a net income make-up charitable remainder unitrust. This type of trust provides that you pay the *lesser of* the income in the trust or the unitrust payment. If there is no income in the trust then no unitrust payment is made. In years in which the income in the trust exceeds the amount of the unitrust payment, the trust can distribute the additional income to the extent that payments in the past were not made. Let's look at an example. Let's assume that you contributed $1 million commercial project to the trust. The project was not yet complete and thus did not yet yield any income. You create a 5% NIMCRUT. The trust owes you $50,000 in the first and second years but has no income in either year. In the third year the trust has $50,000 in income and in each year thereafter the trust has net income of $80,000. To keep the example from being too complicated, let's assume that the property held in the trust does not appreciate, so your unitrust payment continues to be $50,000 per year. In year three, the trust had $50,000 so it could pay the NIMCRUT payment. In year four the trust had $80,000 so it could pay the unitrust payment for that year of $50,000 plus $30,000 of the $100,000 payments which were not paid in years 1 and 2. Years five and six, the trust would also distribute $80,000 in payments. In year seven, the trust will pay out $60,000; the current year's payment of $50,000 plus $10,000 to make up the last of the $100,000 which was not paid in years 1 and 2.

In addition, the capital gain attributable to the appreciation in the property after the trust was created *may* be capital gain, depending on the terms of the trust. The trust must provide that capital gain is considered trust accounting income.

Most of the time, the trust does not work this way. The trust is more likely to have stock or property worth $1 million which it sells, recognizes a large capital gain and then reinvests the proceeds from the sale. The capital gain attributable to the appreciation prior to the time the property is *not* and *cannot be* income for purposes of determining the income in the trust. In addition, the capital gain attributable to the appreciation in the property after the trust was created *may* be capital gain, depending on the terms of the trust. The trust must provide that capital gain is considered trust accounting income. In addition, in certain circumstances, a provision in the trust which allows the trustee to allocate capital gains to income or principal may allow capital gains to be considered income for purposes of determining income in the trust. Believe me, this is a trap for the unwary. I have seen several unitrusts over the years in which the individual recipients understood that capital gains income would be considered trust accounting income. In fact, in trusts which provide for large

unitrust payments, e.g. 10%, it is unlikely that these payments could ever be made without having capital gains be income. Keep in mind if the trust is a straight unitrust, not a NIMCRUT, it does not matter whether there is *any* income in the trust, so the existence of trust accounting income is only relevant in a NIMCRUT.

One method of distributing capital gain is to include a provision in the trust specifying that capital gains are income. Another method is to use a "FLIP" charitable trust. A FLIP is a NIMCRUT which flips to a straight unitrust upon the occurrence of an event. The impact of the NIMCRUT in actual practice should be carefully considered. NIMCRUTS should almost always provide that capital gains are income or provide that they flip to a straight unitrust upon the occurrence of a specified event.

As with most tax techniques, you should consider your overall objectives in light of the benefits and drawbacks of using a charitable remainder trust. In the right situation the charitable remainder trust can be very beneficial, even to the individual with little charitable interest.