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 sole benefit 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.