

# 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.

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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

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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

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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.

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

You are the Trustee and the Beneficiary of the Trust.

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 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

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

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.

### ***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

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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.

### ***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.

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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.

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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?