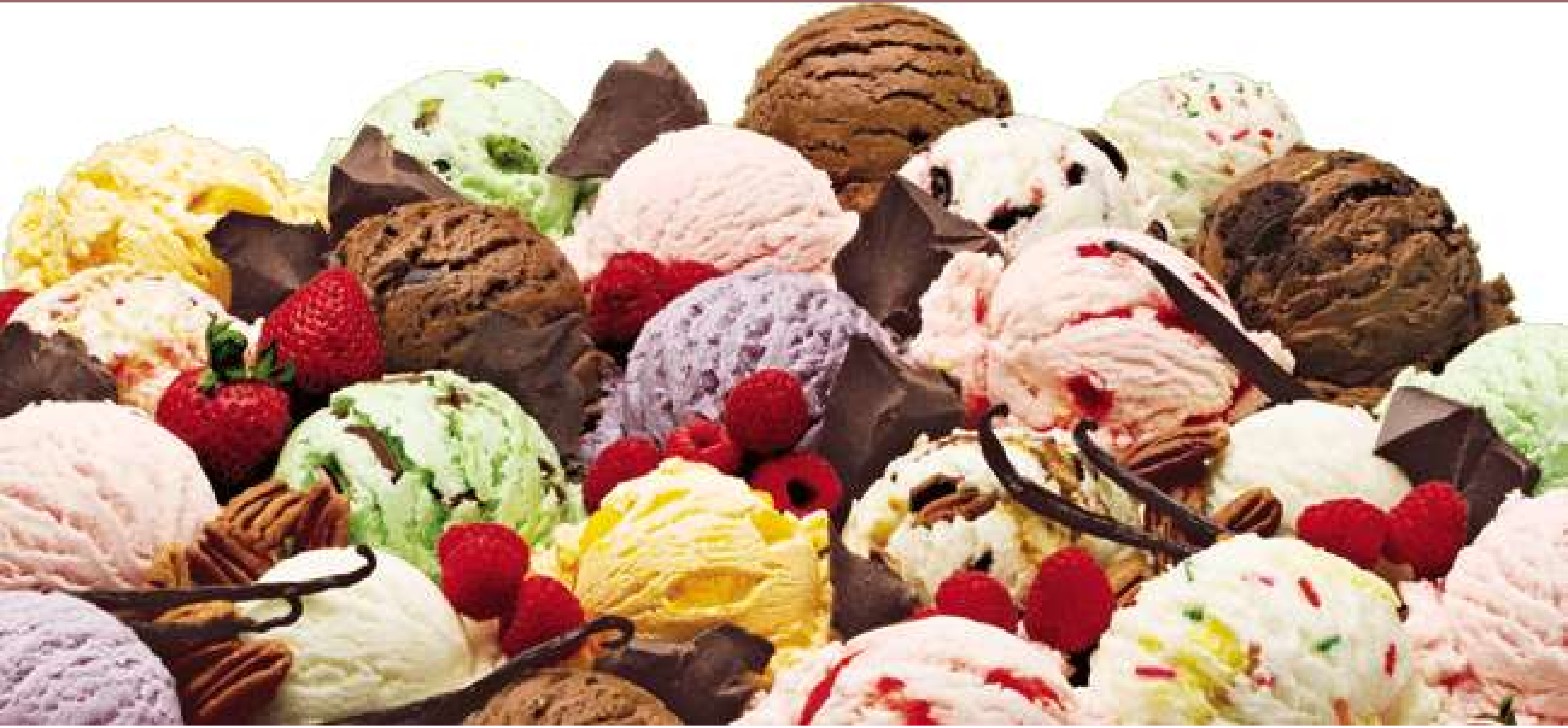
Introduction to Trusts

(Counting Down the "31 Flavors" of Trusts)



*As originally written and presented by Larry C. Rabun, CPA and as edited and presented by **Missia H. Vaselaney.***

AICPA

Taft/

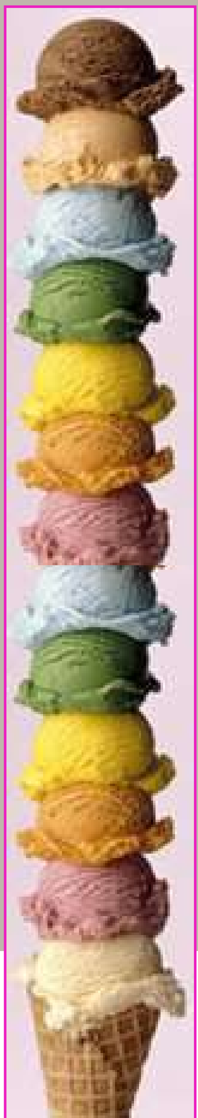
What is a Trust?

31
FLAVORS

- A trust is “a property interest held by one person for the benefit of another.”
- The kinds of trusts are almost limitless.
- No restriction on trust provisions other than the trust must not violate the Rule Against Perpetuities.
- Because of this flexibility, trusts are thought of as the “cornerstone” of estate planning.
- Trusts can be created during lifetime (“intervivos trusts”) or at death (“testamentary trusts”).

There are 3 Categories of Trusts

31 FLAVORS



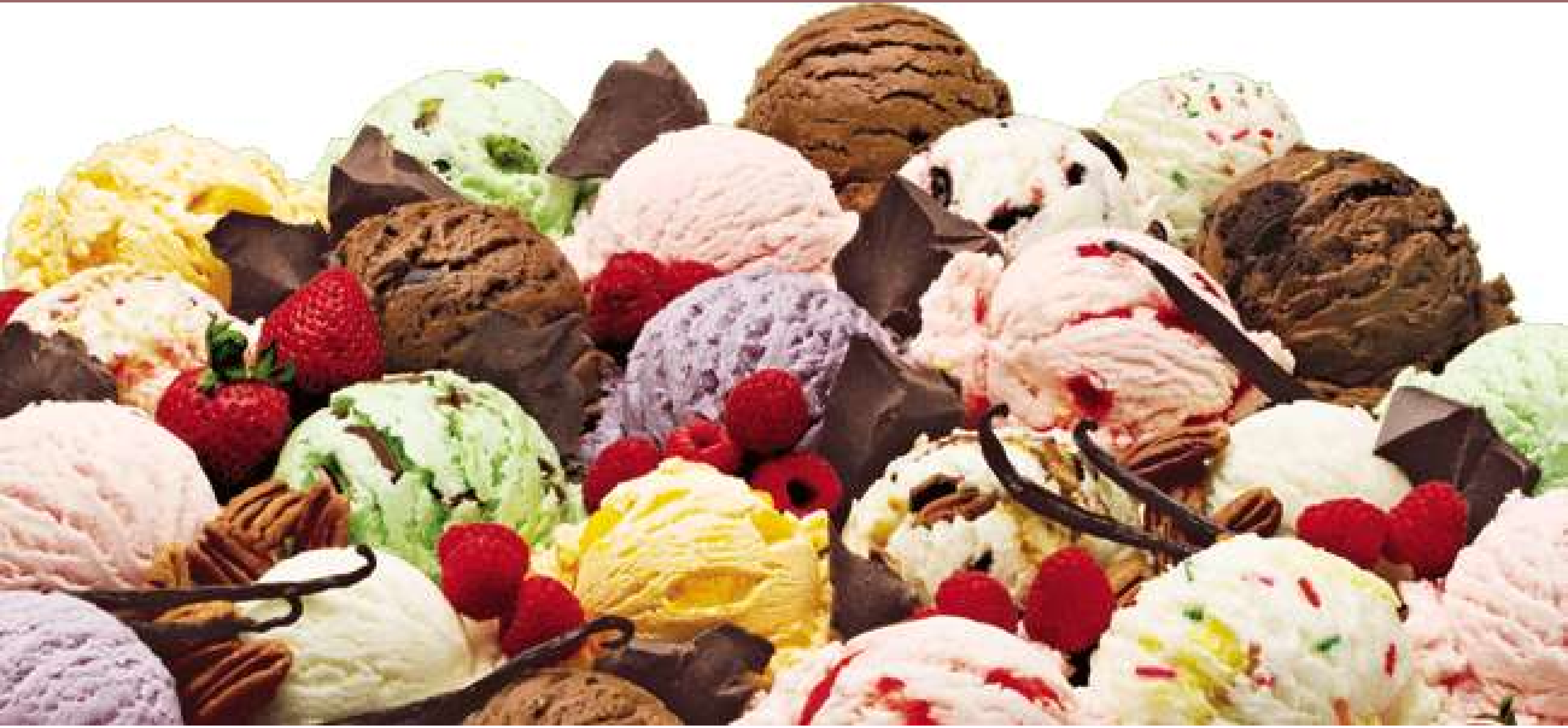
- **Grantor Trusts**
  - All income is subject to income tax to the Grantor regardless of who may actually receive the income.
- **Simple Trusts**
  - Requires the trustee to distribute annually all trust accounting income.
  - The designated beneficiaries are taxable on the income whether or not it is actually distributed.
- **Complex Trusts**
  - All other trusts. Generally, income is taxable to the trust unless it is actually distributed to the beneficiaries.

Revocable vs. Irrevocable Trusts

31
FLAVORS

- **Revocable Trusts**
  - Generally do not save income or estate taxes or result in completed gifts for gift tax purposes.
- **Irrevocable Trusts**
  - May or may not save income taxes or estate taxes.
  - May or may not result in a completed gift for gift tax purposes.
  - The provisions can not be changed by the grantor once the trust instrument has been executed.

Counting Down the “31 Flavors” of Trusts



Taft/

Chicago / Cincinnati / Cleveland / Columbus / Dayton / Indianapolis / N. Kentucky / Phoenix / **www.taftlaw.com**

Blind Trust

1

- Created for the purpose of administering one's investment assets while that person is holding an important position (e.g., public official) where he/she might be making decisions or have special knowledge whereby he/she might be thought to be unfairly benefiting by those decisions or knowledge.
- Generally, the grantor reserves the right to all income as well as the right to request (demand) principal distributions.
- The trust typically terminates at the end of the government position or the death of the grantor, which ever occurs first.

AICPA®

Taft/

Bypass Trust

2

- A trust designed to hold the U.S. estate tax exemption amount to prevent it from being subject to estate tax in the surviving spouse's estate.

Charitable Lead Annuity Trust (CLAT)

3

- A split-interest trust which provides that income is to be paid to one or more qualified charities for a term certain.
  - The income interest must be in the form of a stated percentage of the initial fair market value of the assets placed in the trust.
  - There is no minimum or maximum percentage as there is for a charitable remainder annuity trust.
  - Upon the expiration of that term, the corpus is distributed (or continued to be held in trust for a period) for non-charitable beneficiaries designated by the grantor at the time the trust is created.

Charitable Lead Uni-Trust (CLUT)

4

- A split-interest trust which provides that income is to be paid to one or more qualified charities for a term certain.
  - The income interest must be in the form of a stated percentage of the fair market value of the assets in the trust determined on an annual basis.
  - There is no minimum or maximum percentage as there is for a Charitable Remainder Uni-Trust.
  - Upon the expiration of that term, the corpus is distributed (or continued to be held in trust for a period) for non charitable beneficiaries designated by the grantor at the time the trust is created.

Charitable Remainder Annuity Trust (CRAT)

5

- The opposite of a CLAT.
- The income interest(s) is payable for a term certain (generally limited to a maximum term of 20 years) or for life to non-charitable beneficiaries with the remainder going to qualified charities upon the expiration of the income interest(s).
  - The income interest must be stated as a fixed percentage (minimum percentage of 5%) of the initial fair market value of the assets placed in the trust.
  - The income interest may be payable to the grantor for his lifetime, for the joint lifetimes of the grantor and others (including his spouse) or someone other than the grantor.

Charitable Remainder Uni-Trust (CRUT)

6

- The opposite of a CLUT.
- The income interest(s) is payable for a term certain (generally limited to a maximum term of 20 years) or for life to non charitable beneficiaries with the remainder going to qualified charities upon the expiration of the income interest(s).
  - The income interest must be stated as a fixed percentage (minimum percentage of 5%) of the fair market value of the assets in the trust redetermined annually.
  - The income interest may be payable to the grantor for his lifetime, for the joint lifetimes of the grantor and others (including his spouse) or someone other than the grantor.

Clifford Trust

7

- Was an income shifting technique (codified in section 673) which was repealed by the 1986 Act.
- The trust had to be for a term in excess of 10 years (10 years and 90 days was the most common) and was used to shift income (generally to people whom the grantor was supporting).
- At the end of the term, the corpus of the trust reverted to the grantor.

Crummey Trust

8

- Is not a separate type of trust.
- Contains “Crummey” withdrawal powers in order to permit the donor/settlor to claim gift tax annual exclusions for gifts made to that trust.
  - Gifts in trust generally do not qualify for those exclusions except to the extent of the present value of the income interest and then only if income is required to be distributed currently (i.e., a simple trust).
- Each beneficiary is given the right for a limited period of time (generally, 30 days) after any contribution (gift) to the trust to withdraw the lesser of his/her prorata share of the contribution or $15,000 (currently), whichever is less.
  - This right is noncumulative and expires after the stated withdrawal period.

Defective Grantor Trust

9

- A trust which purposely contains powers that make it a grantor trust for income tax purposes, but not for estate or gift tax purposes.
- Irrevocable

Dynasty Trust

10

- Designed to benefit two or more younger generation beneficiaries (for example, children, grandchildren and perhaps great grandchildren).
- Many times a Dynasty Trust is an irrevocable life insurance trust and owns survivorship or second-to-die policies.

Gallo Trust

11

- A special purpose trust to which grantors were permitted to make one-time special GST tax-free transfers of $2,000,000 to each of their grandchildren.
  - These transfers had to be completed before January 1, 1990.
- It is referred to as the Gallo trust because this provision is generally recognized to have been enacted for the benefit of the families of Ernest and Julio Gallo.

Generation-Skipping Trust (GST)

12

- Has beneficiaries who are at least two generations below the grantor/transferor.
  - For example, a trust for the exclusive benefit of a grandchild is a GST trust. A trust for the benefit of a child and grandchild (or a child and then a grandchild) is also a GST trust.
- The GST rules are perhaps some of the most technical and difficult rules found in the Internal Revenue Code.
- The GST tax was initially enacted in 1976, but was repealed by the 1986 Act retroactively to its date of enactment (1976) because the provisions were so complex that they were unworkable and perhaps even unenforceable.
  - It was replaced by that act with a new GST tax which is (presumably) simpler.

Grantor Trust

13

- The grantor has reserved such significant powers that the trust is deemed to be a “non-entity” for all tax purposes.
- It may be funded or unfunded.
- Upon death, it typically splits into one or more trusts for the benefit of the grantor’s heirs.
- When used in conjunction with a will that “pours over” all probate assets to it, the grantor trust normally contains most, if not all, of the decedent/ grantor’s dispositive provisions.

Grantor Retained Income Trust (GRIT)

14

- The grantor transfers assets to the trust, retains an income interest for a term certain (or his lifetime if shorter) and irrevocably transfers the remainder interest to designated beneficiaries.
  – Upon the expiration of the term, the trust either terminates or continues for the sole benefit of the remaindermen.
- GRITs were first “blessed” in a 1985 private letter ruling, became part of the statute when section 2036(c) was enacted and were significantly changed when Chapter 14 (sections 2701 through 2704) was enacted.

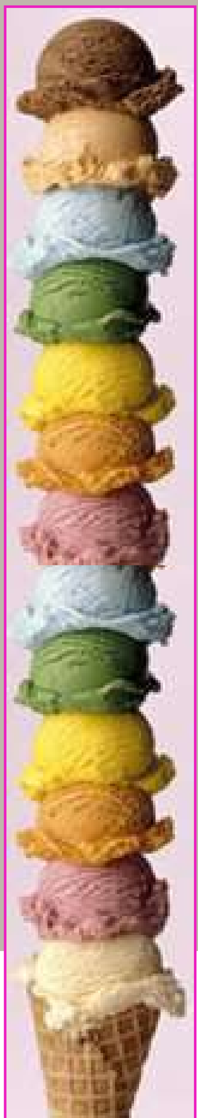
Grantor Retained Annuity Trust (GRAT)

15

- A “refined” version of the GRIT created when Chapter 14 was enacted.
  - It is based on the same basic concepts or principles as a CRAT but is considerably more flexible.
- Under a GRAT, the grantor transfers property to the trust, retains a specified annuity (e.g., 5%) based upon the fair market value of the property transferred to the GRAT when it is created for a specified period of years (or his lifetime, if shorter) and irrevocably transfers the remainder interest to designated beneficiaries.
  - Upon the expiration of the term, the trust either terminates or continues for the sole benefit of the remaindermen.

Grantor Retained Uni-Trust (GRUT)

16



- Another “refined” version of the GRIT created when Chapter 14 was enacted.
- It is based on the same basic concepts or principles as a CRUT but is considerably more flexible.
- Under a GRUT, the grantor transfers property to the trust, retains a specified annuity (e.g., 5%) based upon the fair market value of the property of the GRUT determined annually for a specified period of years (or his lifetime, if shorter) and irrevocably transfers the remainder interest to designated beneficiaries.
  - Upon the expiration of the term, the trust either terminates or continues for the sole benefit of the remaindermen.

AICPA

Taft/

Irrevocable Life Insurance Trust (ILIT)

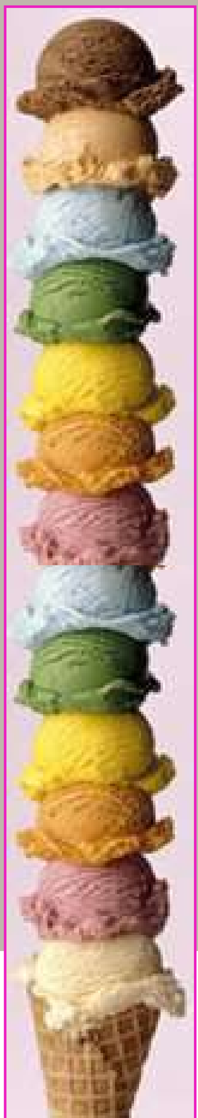
17

- A vehicle for saving estate taxes on life insurance proceeds without changing the economic situations of the persons for whose benefit those proceeds will be used.
- There are two basic scenarios:
  - Policies insuring only one spouse and;
  - Policies insuring the lives of both spouses that pay only upon the death of the surviving spouse.
- May either be funded or nonfunded.
  - In which case the grantor (or the grantor's employer) will have to make contributions (or deemed contributions) to pay the premiums.

AICPA

Irrevocable Retirement Benefit Trust

18



- Created for the purpose of receiving funds from an IRA at the death of the IRA owner.
- Treated as a designated beneficiary.
- Allows for the distribution of the funds over the lifetime of the trust beneficiary.

Marital Deduction Trust

19

- A trust, generally funded at death, that meets the requirement of Section 2056 and allows a deduction from the decedent's gross estate for the value of property interests passing from the decedent to the decedent's surviving spouse.
- Also known as Q-TIP, QDOT, QDT, Withdrawable Marital Trust, General Power of Appointment Trust, Estate Marital Trust.
- Irrevocable at death.

Minor's Trust

20

- Created for the benefit of a minor that allows transfers to the trust to qualify for the $15,000 annual gift tax exclusion even though the minor's right to present enjoyment of the gifts is delayed until age 21.
- Also known as 2503(c) trust; 2503(b) trust.
- Irrevocable

Pot Trust

- An annual exclusion trust created for multiple beneficiaries (children, grandchildren or both).
- Beneficiaries are given annual withdrawal rights.
- Also known as Annual Exclusion Trust, Crummey Trust, or Separate Share Trust.
- Irrevocable

Protective Trust

22

- Created to place the income and/or principal beyond the reach of creditors, business risks, divorce, or other problem areas.
- Also known as a Spendthrift Trust.
- Irrevocable

AICPA®

Taft/

Qualified Domestic Trust (QDOT)

23

- Created to hold property passing from a decedent to a non-citizen spouse so that the passing property qualifies for the estate tax marital deduction.
- Also known as QDOT, QDT, Non-citizen marital trust.
- Irrevocable

Qualified Subchapter S Trust (QSST)

24

- Special trust which is a statutory exception (section 1361(d)) to the general rule that trusts can not be qualified S shareholders.
- The trust terms must require that:
  - During the lifetime of the current income beneficiary, there shall be only one income beneficiary of the trust;
  - Any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary;
  - The income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and;
  - Upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary.
  - Also, all of the income must be distributed (or required to be distributed) currently to one individual who is a citizen or resident of the U.S.

Qualified Personal Residence Trust (QPRT)

25

- A trust created to hold the grantor’s personal residence where a gift of a remainder interest in the residence is made to children or other beneficiaries and the grantor retains right to reside in the home for a specified period.
- Irrevocable

Qualified Terminable Interest Property Trust (QTIP)

26

- Created to hold property for the benefit of a surviving spouse that qualifies for the marital deduction while the decedent spouse maintains control over the ultimate disposition of the assets.
- Irrevocable

AICPA

Taft/

Rabbi Trust

27

- A funded irrevocable trust established by an employer to provide future deferred compensation payments where the employee is not taxed until funds are actually distributed.

Reciprocal Trusts

28

- Created by individual grantors under an arrangement whereby each grantor places property in trust for the benefit of the other grantor and each trust provides essentially identical benefits.
- Irrevocable

Secular Trust

29

- An irrevocable trust established to receive employer contributions and pay out benefits under a nonqualified deferred compensation plan.
- The assets in a secular trust are beyond the reach of the company's management and creditors; however, the employee has current income for income tax purposes.

Spray (Sprinkle) Trust

- Created to give the trustee discretion over the distribution of income and/or principal among several beneficiaries.
- Also known as a Discretionary Trust.
- Irrevocable generally

Wealth Replacement Trust

31

- Created to replace the assets that a grantor removes from his or her estate through the creation of a charitable remainder trust.
- Is generally an irrevocable life insurance trust.

AICPA

Taft/

Questions?

Missia H. Vaselaney
Partner
Taft Stettinius & Hollister LLP
200 Public Square, Suite 3500; Cleveland, OH 44114
(216) 706-3956
mvaselaney@taftlaw.com