BEYOND THE FUNDAMENTALS: INTRODUCTION TO COMMON ESTATE PLANNING TECHNIQUES

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OVERVIEW

Part I. Lifetime Gifting & Irrevocable Trusts (Christine)

- Introduction to Common Gifting Techniques
- Irrevocable Trusts as Estate Planning Tools

Part II. Modification of Irrevocable Trusts (Julie)

Alternatives to Judicial Modification

- Trust Merger
- Decanting
- Virtual Representation

THE NARROWING TAX NEXT

Year	Federal Estate Tax Exemption	Maximum Rate	Exemption in 2019 Dollars*
1919	$50,000	25%	$765,114
1929	$100,000	20%	$1,512,118
1939	$40,000	70%	$740,719
1949	$60,000	77%	$641,543
1959	$60,000	77%	$528,720
1969	$60,000	77%	$422,393
1979	$147,000	70%	$532,090
1989	$600,000	55%	$1,245,563
1999	$650,000	55%	$999,436
2009	$3,500,000	45%	$4,194,419
2019	$11,400,000	40%	$11,400,000

*Calculated using Bureau of Labor Statistics CPI Inflation Calculator

OUTRIGHT LIFETIME GIFTS

- Annual Exclusion Gifts
  - IRC § 2503(b)
  - IRC § 2642(c)
- Educational/Medical Exclusion Gifts
  - IRC § 2503(e)
  - IRC § 2642(c)
- Gifts to 529 Plans

WHY ADVANCED ESTATE PLANNING?

People make lifetime gifts to irrevocable trusts for many reasons, including:

- Freezing the value of the estate. This excludes future appreciation on assets from the gross estate.
- Protecting property from the creditors of beneficiaries.
- Seeding irrevocable trusts in preparation for future transfers.
- Taking advantage of the “tax exclusive” nature of the gift tax as opposed to the “tax inclusive” nature of the estate tax.

INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

- Grantor transfers trust property to third party under a trust agreement.
  - Grantor may act as investment advisor if it would not cause estate tax inclusion under IRC § 2036(b).
  - Irrevocable trust, completed gift.
- Trust is generally “seeded” with a relatively small amount of assets.
- Trust may include “Crummey” withdrawal rights.
- Trusts often include grantor trust provisions to maintain grantor status during life regardless of who is trustee or beneficiary.

CRUMMEY POWERS: TO LAPSE OR TO HANG?

- Lapsing withdrawal rights – beneficiary's right to withdraw lapses after period of time (i.e., 30 days). Must lapse in an amount under $5,000/5% of the trust principal.
- Hanging withdrawal rights – lapse each year to the maximum extent they would not give beneficiary a general power power of appointment.
  - Open "hanging Crummeys" are included in beneficiary's estate at death.
- Avoid naked Crummeys. See *Cristofani.*
- Present Interest Requirement. See *Hackl, Price.*

WITHDRAWAL LANGUAGE EXCERPTS

A beneficiary may only exercise a withdrawal right with respect to a contribution to the trust of property as to which the donor or the donor's spouse could claim a gift tax annual exclusion under Code Section 2503(b) if the property were given outright to the beneficiary.

Any withdrawal right granted under this Article shall terminate *wholly or partially in each calendar year of the trust as soon as and to the maximum extent that such termination does not result in a release of a general power of appointment under Sections 2514(e) and 2041(b)(2) of the Code by the beneficiary holding the power, but* not sooner than thirty days after the date of the contribution, or on the day preceding the date of death of that beneficiary, whichever shall occur first.

Italicized language represents hanging power.

THE POWER OF GRANTOR TRUSTS

- Code sections 671-679 provide that certain trusts will be taxed to the "grantor," meaning the person who made the initial gift to the trust.
  - These generally include trusts that are for the benefit of the donor or the donor's spouse, and trusts over which the donor retains certain administrative powers.
- If an irrevocable trust is a grantor trust, the grantor pays income tax on trust income from his or her separate, non-trust assets.
  - Viewed as the ability to make a tax-free gift in trust.
  - Trust assets thereby grow income-tax free.

COMMON GRANTOR TRUST POWERS

Some of the more common methods of intentionally triggering grantor trust status include:

- Grantor retains the power in a nonfiduciary capacity to substitute assets of an equivalent value, exercisable without approval or consent of adverse party. IRC § 675(4)(c).
- Grantor retains the power to borrow without adequate interest or security. IRC § 675(2).
- (Independent) trustee may add charitable beneficiaries. IRC § 674.

This list is not exhaustive!

GRANTOR AS TRUSTEE/APPOINTER

- Grantor's reservation of power to remove trustee and appoint a "672" independent trustee is not a retained power under IRC §§ 2036 or 2038. Rev. Rul. 95-58. Also see *Wall, Vak.*
  - By extension, a beneficiary can also remove a trustee and replace with an independent trustee.
- Can the grantor retain the power to appoint a non-independent trustee?
- Can the grantor act as trustee if limited to an ascertainable standard?

IRREVOCABLE LIFE INSURANCE TRUSTS

- Generally a type of IDGT. Trust income applied to the payment of life insurance premiums on grantor or grantor's spouse causes grantor trust status. IRC § 677(a)(3).
- Irrevocable life insurance trusts (ILITs) are created to hold insurance on the life of the donor so that insurance policy proceeds will not be includable in the donor's taxable estate.
  - Under Code Section 2042, policy proceeds will be taxable in the donor's gross estate if the donor has "incidents of ownership."
  - Under Code Section 2035, policy proceeds will be taxable in the donor's gross estate if the donor made a gift of the policy within three years of death. *This is why existing policies are often sold and not gifted to insurance trusts.*
- Historically, the ILIT was often the first irrevocable trust created as individuals accumulated wealth.

PURPOSES OF LIFE INSURANCE

- Liquidity, i.e., to pay estate taxes
  - Life insurance trusts do not – and cannot – pay estate taxes directly. This would result in the corpus being taxable to the estate because it would be used to discharge an obligation of the estate.
  - Life insurance creates liquidity, and proceeds are often borrowed by the executor to pay estate taxes.
- Wealth replacement
- Income replacement

DRAFTING LIFE INSURANCE TRUSTS

- The grantor should not also act as trustee and should have no other incidents of ownership.
- Often include many of the same provisions as garden variety IDGTs.
- Historically, practitioners were concerned that a substitution power could cause estate tax inclusion. Approved under Rev. Rul. 2011-2008.

VALUE OF LIFE INSURANCE POLICY TRANSFERRED

- If transferring existing policies to trust, consult Treas. Reg. § 25.2512-6 for definition of fair market value.
  - Interpolated terminal reserve value (as reported on Form 712) can't be used if grantor is terminally ill.
- If selling policy to a trust, important not to violate the "transfer for value" rules of IRC § 101(a)(2). Violation causes policy proceeds to be subject to income tax.
  - Sale from grantor to grantor trust is treated as a sale to self, and therefore disregarded under IRC § 101(a)(2).

IDGT VARIATIONS

- Loans and Sales to IDGTs
  - Observe applicable federal rate
  - Seed money: 10% vs. commercially reasonable/economic substance
  - Beneficiary guarantees
- Grandchildren's Annual Exclusion Trusts; aka *Crummey Trusts* (includable in the estate of the single beneficiary).
- Minor's Trusts under IRC § 2503(c).
  - Single, minor beneficiary. Right to withdraw at age 21 (usually limited to 30 day window). Must be includable in minor's estate in case of death before age 21. Illinois law allows custodian to convert UTMA account to Minor's Trust.

GRANTOR RETAINED ANNUITY TRUSTS

- In general, Code Section 2702 applies to disregard the value of a retained interest other than a "qualified interest" where a donor makes a gift in trust. An annuity for a term of years satisfies the "qualified interest" exception under IRC § 2702(b).
- All growth in excess of 7520 rate (120% of midterm AFR) passes to designated beneficiaries
- Zeroed-out GRATs, aka "Walton" GRATs, permitted under Treas. Reg. § 25.2702-3(e), Ex. 5
- Work well in low interest, high growth environment

PLANNING LIMITATIONS

- If grantor dies during annuity term, GRAT property is includable in estate under IRC § 2036.
- GST exemption cannot be allocated until end of estate tax inclusion period, meaning the end of the annuity term. IRC § 2642(f).
- No certainty as to minimum term; generally accepted as two years.

DRAFTING REQUIREMENTS

Under Treas. Reg. § 25.2702-3:

- Qualified annuity interest:
  - Stated dollar amount or stated percentage of initial fair market value;
  - May increase up to 20% per year.
- Payable to holder for fixed term.
- No distributions to anyone other than annuitant during annuity period.
- Annuitant's interest may not be commuted.
- Additional contributions to trust prohibited.

ANNUITY PAYMENT REQUIREMENTS

- Must be paid at least annually, subject to 105 day grace period.
- Prorated for short years.
- Generally paid to grantor’s estate after death.
- Cannot be paid with debt instruments.

QUALIFIED PERSONAL RESIDENCE TRUSTS

- Inverse of a GRAT. In a GRAT, grantor receives back initial trust property (or equivalent value) and excess passes to remainder beneficiaries. In a QPRT, initial trust property passes to remainder beneficiaries after grantor's use (i.e., as income beneficiary) for a term of years.
- May be used for principal residence of grantor, one other residence, or an undivided interest in either. May include appurtenant pertinent structures and reasonably appropriate adjacent land. Treas. Reg. § 25.2702-5(c)(2)(i).

PLANNING LIMITATIONS

- If grantor dies during term, QPRT property is includable in estate under IRC § 2036.
- GST Exemption cannot be allocated until end of estate tax inclusion period, meaning the end of the term. IRC § 2642(f).
- Grantor must move out or lease after end of term.

DRAFTING REQUIREMENTS

<u>Under Treas. Reg. § 25.2702-5:</u>

- Income must be distributed to term holder at least annually.
- Corpus may not be distributed to any beneficiary other than term holder during term.
- Trust may not hold anything other than personal residence, except:
  - May hold cash for six months of expenses/improvements; and
  - If property is sold, may hold cash for up to 2 years. Proceeds must be reinvested in new residence, or trust converted to GRAT.
- Property may not be sold to term holder, spouse, or a controlled entity while a grantor trust.
- Term holder’s interest may not be commuted.

CHARITABLE REMAINDER TRUSTS

- Irrevocable trust created under IRC § 664.
- May be inter vivos or testamentary, grantor or non-grantor.
- One or more individuals receive annuity or unitrust for a term of years (up to 20) or for life:
  - If a unitrust, not less than 5% of assets determined annually.
  - If an annuity trust, not less than 5% of initial fair market value of assets.
- Annual payout may not exceed 50% of fair market value of assets.
- At end of term (or death), remaining assets pass to charity.

CRAT vs. CRUT

- CRUTs permit additional contributions. Treas. Reg. § 1.664-2(b). CRATs do not.
- A CRUT may prohibit unitrust payments in years in which income is insufficient (“NICRUT”). The trust instrument may require that “catch up” payments must be made in later years (“NIMCRUT”). IRC 664(d)(3).
- A CRUT may convert from a NICRUT to a traditional CRUT on the happening of certain events outside the control of the donor, such as death or the sale of a closely held business (“FLIPCRUT”). Treas. Reg. § 1.664-3(a).

CHARITABLE LEAD TRUSTS

- Irrevocable trust, may be inter vivos or testamentary
- Charity receives annuity or unitrust annually for a term of years or for life. No minimum payout; no maximum term.
- Nongrantor charitable lead trusts
  - No upfront income tax deduction to grantor
  - Grantor receives gift/estate tax deduction
  - Taxed as complex trust; receives IRC § 642(c) charitable deduction
- Grantor charitable lead trusts
  - Income tax deduction on funding = value of lead interest
  - Grantor taxed on subsequent income
- Private Foundation excise taxes (IRC §§ 4941-4945) generally apply.

What happens when the client wants to “amend” the irrevocable trust?