ADVANCED PLANNING

Wealth Strategies

Understanding the Uses of Trusts

WEALTH TRANSFER

OVERVIEW.

The purpose of this brochure is to provide a general discussion of basic trust principles. It includes the essential elements of trusts, their advantages, tax and non-tax reasons for using them, and the various types of trusts used by individuals in their estate documents.

SHOULD YOU HAVE A TRUST?

Reasons for establishing trusts are as different as the people who have them. But regardless of the difference in their personal circumstances, many people discover that a trust is a smart addition to their estate strategy.

A properly structured trust can be a prudent way to hold and distribute assets. Depending on the type of trust established, it can simplify financial life, reduce estate taxes, and allow for greater control over asset management and distribution after death. These are all important potential benefits of establishing a trust. Since Prudential and its financial professionals cannot give tax or legal advice, we encourage individuals to consult with their tax and legal advisors to explore the concepts discussed below. This group can work with the individual to help determine if, and how, a trust can be used as part of the individual's estate strategy.

WHAT IS A TRUST?

A trust is a legal entity in which one person holds property in a fiduciary capacity for the benefit of another person. This legal entity is separate and distinct from the person who:

- Creates the trust.
- Holds legal title to the trust property and administers the trust.
- Benefits from the trust.

ESSENTIAL ELEMENTS OF A TRUST.

In order to understand the basics of a trust, it is important to understand the basic terminology. Here are a few definitions and explanations to help you better understand the essential elements of a trust.

- **Grantor**
  The grantor establishes the trust and transfers money or other property to it. The grantor may also be called the "settlor," the "donor," or the "testator." The use of any of these terms depends on specific state statutes and whether the trust in question has been created during life or by a will.

1000318-00002-00 Ed. 01/2020

- **Trustee**
  The trustee holds legal title to the money or property in the trust. The trustee has many responsibilities, but the main focus is on managing and distributing trust property for the beneficiaries of the trust in accordance with the terms of the written trust document. A trust may have one or more trustees. The trustee(s) may be an individual(s) or a corporate entity, such as a bank or trust company.

- **Successor Trustee**
  The successor trustee is the person or entity who takes over as trustee of the trust if the original trustee(s) is unwilling or unable to continue in the capacity of a trustee.

- **Beneficiary**
  Every trust must have at least one beneficiary, but may have more. These beneficiaries can be individuals or organizations, and a trust will typically specify an income beneficiary and a remainder beneficiary.

  A person or an organization who is legally entitled to receive trust income or to whom the trustee is required to provide an income is an "income beneficiary."

  A person or an organization who is entitled to benefits from the trust principal after the income beneficiary's interest terminates is called a "remainder beneficiary" or "remainderman."

  A "primary beneficiary" is a person who will directly benefit from the trust.

  A "contingent beneficiary" is a person who may become a beneficiary, depending on the occurrence or nonoccurrence of certain events specified in the trust.

- **Trust Res**
  Trust res (or corpus) is the specific identifiable property, or an interest in such property, that is transferred to the trust. Title to the property must be transferred to the trustee to establish a valid trust. Most jurisdictions recognize that a valid trust may be formed where the trust is named as the beneficiary of a life insurance policy.

THE VALUE OF USING LIFE INSURANCE WITHIN A TRUST.

A trust is a vehicle for assets rather than an asset in and of itself. Depending on an individual's needs and the type of trust, the different types of assets they place within it are wide-ranging; they can include securities, annuities, real estate, or life insurance, among others.

Life insurance as a funding vehicle inside trusts offers many advantages. Relatively small amounts of premiums can be used to create a large amount of money using life insurance. If there is a premature death in relation to the trust, life insurance could be used to cover any potential tax liability. Placing life insurance within a trust can increase the impact of a gift or be used to provide greater control over how the payout from the death benefit can be transferred to the beneficiaries.

Other examples of using life insurance in a specific type of trust:

- Depending on the trust and how it is structured, the death benefit can be used only to provide income, or it can provide income during the lifetime of a surviving spouse and then distribute to secondary beneficiaries such as in a Qualified Terminable Interest Property (QTIP) trust or a remainder type of trust.

- Life insurance can be used to replace a valued asset such as low-basis stock being given to a charity in order to provide for loved ones, while still fulfilling charitable and tax strategy goals.

- Life insurance as a wealth replacement vehicle is useful when a tax strategy is needed and highly valued assets are desired to be kept inside the estate.

TYPES OF TRUSTS.

Trusts have many varied uses and purposes. Some trusts may be established during a grantor's life for his or her own benefit or for the benefit of others. Others come into being only at death. Some trusts are drafted for the flexibility they give the grantor, while others may focus on tax savings. There are two major classes of trusts: living and testamentary. Living trusts can be either revocable or irrevocable, and testamentary trusts are created at death based on the instructions in your will. The discussion that follows focuses on some of the more commonly used trusts, including an explanation of any tax advantages.

- **Revocable Living Trust**

  A revocable living trust is a trust created during the grantor's lifetime and allows the grantor (you) to maintain total control over the trust during your life. For instance, the grantor can change the trustee, withdraw property from the trust, or terminate the trust altogether. It becomes effective once the grantor and trustee sign the trust document and property is transferred into the trust. Upon the grantor's death, the revocable living trust terminates or becomes irrevocable. Because of the grantor's ability to revoke the living trust, this type of trust does not provide any tax advantages.

  A revocable living trust is an efficient and effective way to transfer property at the time of the grantor's death. Other estate objectives that can be met by using a revocable living trust include:

  Advantages

  - **Reduction of Probate Costs.** Property passing under a will is subject to attorney's and executor's fees and court costs associated with probating the estate. Property transferred during the grantor's lifetime to a revocable living trust is generally not subject to probate expense.
  - **Elimination of Probate Delays.** A revocable living trust avoids the delay of probate proceedings and permits beneficiaries to receive property more quickly.
  - **Privacy.** Wills are often made public as part of the probate process. Since a revocable living trust is not subject to probate, generally its contents do not have to be revealed. The beneficiaries and trust assets can be kept confidential from outsiders.
  - **Avoidance of Multiple Probate Proceedings.** Real estate owned by a decedent that is located in a state other than the decedent's state of principal residence may require separate probate proceedings in that state. Separate probate proceedings may be avoided by transferring the out-of-state real estate into a revocable living trust.
  - **Management of Property in the Event of Disability.** The trustee can manage the trust property for the benefit of a disabled or incapacitated grantor without incurring the expense of court involvement in appointing a guardian of the property. The trust can provide continuity of investment and management of assets after the grantor's death. This is an important factor if the trust beneficiaries are unwilling or unable to manage the trust property.

  Disadvantages

  - **Initial Costs of Creating a Revocable Living Trust.** Normally the cost of creating a revocable living trust exceeds that of a comparable will. The trust instrument and a separate "pour-over" will must still be drafted. Additional legal documents, such as deeds and other documents used to transfer ownership, may be necessary to fund a revocable living trust.
  - **Probate Proceedings May Be Unavoidable.** The grantor may hold additional property outside the living trust that may require separate probate proceedings. In addition, many states allow creditors a certain period of time to file a claim or be forever cut off. The only way to trigger this process is to initiate a probate proceeding.

- **Funding the Revocable Living Trust Can Be Time-Consuming.** The trust is created during the grantor's lifetime and becomes operative when funded. The transfer of stock certificates, corporate and government bonds, real estate, and other assets can be a time-consuming and often frustrating experience. If the funding of the trust is not completed, the goal of avoiding probate will not be achieved.

- **Irrevocable Living Trust**
  An irrevocable living trust is a trust that is established by the grantor while he or she is still alive, which, by its terms, cannot be revoked or terminated by the grantor. One reason for the irrevocable nature of this trust is to place the trust assets outside the grantor's taxable estate. An irrevocable life insurance trust (ILIT) is probably the most common example of an irrevocable living trust.

- **Testamentary Trust**
  A trust established under a decedent's will is known as a testamentary trust and the grantor is referred to as the "testator," that is, the maker of the will. Testamentary means "at death," and such a trust has no legal value or effect until the testator's death. That is, a testamentary trust does not come into being until the testator dies. Since a testamentary trust is not actually established until death, the trust may be modified or revoked by amending the will. After the grantor's death, the testamentary trust becomes an irrevocable trust. Because a testamentary trust does not come into being until the death of the testator, the assets that ultimately fund the trust are subject to estate tax in his or her estate.

SELECTION AND DUTIES OF A TRUSTEE.

Trustee Duties
A trustee has a broad duty to act in a fiduciary capacity on behalf of the beneficiaries while complying with the terms of the trust document and applicable state laws. The trustee's duties generally include:

- **Investments.** The trustee controls the trust assets. The trustee must invest and reinvest the trust assets in a prudent manner.

- **Distribution.** The trustee is responsible for making trust distributions as directed by the terms of the trust document.

- **Accountings.** The trustee must provide trust accounts to the beneficiaries and/or the probate court, as provided by the trust instrument or under applicable state laws.

- **Taxes.** The trustee is responsible for preparation of the trust's tax returns and payment of any taxes owed by the trust. A revocable trust generally does not require a separate tax return.

- **Trust Termination.** The trustee must distribute the trust property at the end of the trust term in accordance with the provisions of the trust document.

Factors in the Selection of a Trustee
The trustee (or a successor trustee) may be one or more individuals, an institution (e.g., a corporate trustee or charitable organization), or a combination of both. The trustee has ongoing obligations to the trust beneficiaries. Due to the serious nature of the role, the trustee should be reliable and honest, and possess a good understanding of how the trust works. It is a good practice to name at least one, and preferably two, successor trustees. Other factors to consider before deciding whom to select as trustee include:

- **Duration of Trust.** When the trust is intended to last for the lifetime of a beneficiary, or for the maximum period of time permitted by law, it may be advisable to name a corporate entity as the ultimate successor trustee. Alternatively, the trust can permit the individual trustee(s) to select their own successors. A named corporation (or successor to the corporation) normally is available when called upon to serve.

- **Size of the Trust.** A corporate trustee may have minimum size requirements for a trust, whereas individual trustees usually have no such requirements.
- **Investment Capabilities and Philosophy.** A corporate trustee may have greater resources and knowledge with respect to the investment and management of trust assets than an individual trustee. A corporate trustee may be a more conservative manager than an individual in selecting investments. The grantor must decide whether the trustee will have an investment philosophy that is compatible with his or her own.
- **Costs.** Individual trustees may be willing to serve without compensation or at lower rates than a corporate trustee.
- **Availability of Individuals.** Clients who are considering individuals, such as family members, to serve as trustee must make sure that these individuals have the time, the willingness, and the ability to properly manage trust assets.
- **Beneficiary Understanding.** An individual trustee may have greater personal knowledge of the grantor's desires and be more in tune with the needs of individual beneficiaries. However, an individual trustee may be reluctant to make difficult decisions or resolve conflicting interests involving family members. A corporate trustee is not tied emotionally to the beneficiaries and may be more capable of making impartial decisions.
- **Co-Trustees.** Use of an individual and a corporate trustee may balance diverse interests and talents but may increase trustee fees. The trust should clearly identify how the trustees will act, such as how many trustee signatures are needed to execute transactions.
- **Tax Considerations.** If the grantor names himself as trustee, his or her powers over principal and income may make the trust income taxable to him or cause inclusion of the trust assets in his or her estate.

MAXIMUM TRUST LIFE.

Generally, most states allow trusts to continue for the life of the youngest beneficiary plus 21 years. This is referred to as the rule against perpetuities.

Many states have repealed their rule against perpetuities (or permit elections to have the trust not be subject to the rule), allowing the creation of perpetual trusts. In these states, trusts can live on forever.

For example, assume the youngest beneficiary of a trust lives for 80 years. Using the rule against perpetuities, the trust could continue on for 80 years + 21 years = 101 years. This is why it is so important to have contingent trustees to carry on the affairs of the trust.

One benefit of retaining property in trust for a long period of time is the avoidance of estate taxes. Such a multiple-generation trust is sometimes referred to as a "Dynasty Trust."

NON-TAX BENEFITS OF TRUSTS.

Trusts are generally implemented to reduce or minimize transfer tax consequences (i.e., gift tax, estate tax, and generation-skipping tax). However, it is important to realize that trusts are more than tax-efficiency tools. They offer advantages other than tax savings. The following is a short discussion of some of the non-tax advantages of using trusts.

- **Grantor Control**
  Through the terms of the trust document, the grantor can control the manner in which the property is invested and the way income and principal are distributed to the beneficiaries, even after his or her death.

- **Financial Management**
  A properly selected trustee can provide financial management for beneficiaries who are not capable of handling such matters. Frequently, trustees are selected for their good judgment, even though they may have little financial management experience. In these situations, trustees have the authority to hire accountants, attorneys, financial professionals, or other professionals to advise them.

- **Protection Against Creditors**
  A spendthrift provision in the trust instrument may protect a beneficiary's interest in the trust property against claims made by his or her creditors until the income or principal of the trust is distributed. Thus, a spendthrift provision can serve as protection if the beneficiary becomes involved in bankruptcy or divorce proceedings.

- **Flexibility in Dispositive Arrangements for Family Members**
  Specific terms in the trust relating to distribution of income or principal can help to assure that a young child's inheritance will be distributed according to the parent's wishes. Some advantages in using trusts with respect to the future benefit of children are:

  - **Grantor Sets the Rules.** The grantor can set the standard for making discretionary trust distributions by directing the trustee to be generous or to make distributions sparingly to encourage beneficiary self-sufficiency.

  - **Meeting Differing Needs of Children.** As stipulated by the terms of the trust document, the trustee can have the power to allocate funds unequally among the children, according to their respective needs and ages. For example, if one child receives a college scholarship for tuition and another child is not so fortunate, the trustee can have the flexibility to allocate a greater proportion of the trust to help pay the college expenses of the second child.

  - **Avoids Conservatorship.** If a minor inherits property outright upon death (rather than through a trust), the court will appoint a guardian or conservator to administer (protect) the property on behalf of the minor. This court procedure is costly and cumbersome.

  - **Use of Staggered Distribution Ages.** The trust instrument can direct a staggered distribution of trust property at specified ages so that the beneficiaries receive the property in stages. This is a common method for making distributions to children because it allows greater time for the children to mature and learn how to handle financial affairs. An example might be income annually plus 1/4 of trust corpus at age 25, 1/3 at age 30, 1/2 at age 35, and the remainder at age 40. If no trust is in place, the children's inheritance will be distributed to them at the age of majority.

  - **Caring for a Disabled Beneficiary.** A trust can permit the grantor to make special arrangements for a disabled beneficiary who may need care and financial help for life. The trust may direct the trustee to provide payment for medical expenses and a broad range of other costs.

  - **Protection Against Unexpected Order of Deaths.** Specific provisions can be included in a trust to provide instructions in the event of a beneficiary's death before, after, or simultaneous with that of the grantor. A trust in effect at the beneficiary's death can insulate property from estate taxes and claims of a spouse and/or creditor.

COMMON TRUSTS IN ESTATE DOCUMENTS.

This section focuses on specific types of trusts often included in estate documents. While many of the trusts result in transfer tax savings, more importantly, they allow the grantor to do what he or she really wants to do with his or her wealth. The ability to provide continued care for a spouse or minor children, to support a favorite charity, and to ensure a grandchild's education are just a few of the common objectives that can be managed through a trust.

For married couples, one of the most common objectives is to ensure that maximum use is made of each spouse's applicable exclusion amount, though with portability of the applicable exclusion, this need is reduced for smaller estates.

A common estate technique involves using a credit shelter trust in conjunction with the unlimited marital deduction to defer estate taxes until the death of the surviving spouse. First, a discussion of the basic components of this technique.

- **The Applicable Exclusion Amount**
  U.S. citizens and residents are allowed a tax credit against taxes stemming from their cumulative dispositions of property. This results in an individual's ability to transfer property during life and/or at death free of estate and gift taxes. The value of property that can be transferred without gift or estate tax—known as the applicable exclusion amount—is the amount that would generate a gift or estate tax liability equal to the allowable applicable credit.

  The Tax Cuts and Jobs Act of 2017 doubles, through 2025, the estate, gift, and generation-skipping transfer (GST) taxes, which are unified and indexed for inflation, rounded down to the nearest $10,000. In 2020, the amount is $11.58 million per person, or $23.16 million per married couple. The highest tax rate is 40% and there continues to be a full step-up in basis for capital assets, excluding income in respect of a decedent (IRD).

  Executors can now permanently transfer the unused applicable exclusion (estate or gift) to a decedent's surviving spouse with the timely filing of an estate tax return. In all years, the estate tax applicable exclusion amount available at death is reduced by the gift tax applicable exclusion amount used during the individual's lifetime. The following chart summarizes the changes to the estate tax applicable exclusion amount:

YEAR OF DEATH	APPLICABLE EXCLUSION AMOUNT	UNIFIED CREDIT AMOUNT
2020 and beyond	$11,580,000	$4,577,800

- **Unlimited Marital Deduction**
  The biggest single step that most married couples can take to defer estate taxes at their death is to qualify the transfer of property for the unlimited marital deduction.

  This allows the first spouse to die to leave all of his or her property to the surviving spouse and avoid federal estate taxes. The marital property will be included in the estate of the surviving spouse and potentially subject to taxation at his or her death. Now with permanent portability, the decedent can pass any unused applicable exclusion to their surviving spouse.

  If the surviving spouse is a U.S. citizen, the marital bequest can be made outright or in trust.[1] Some factors to consider when deciding whether a marital trust should be considered are as follows:

  - The cost of establishing and administering the marital trust compared with the value of the property that would be transferred into the trust.

- The effect of applicable state law entitling the surviving spouse to a specified percentage of the deceased spouse's estate. The creation of a trust for the surviving spouse may cause him or her to elect a statutory share under state law, thereby defeating the deceased spouse's wishes.

- The surviving spouse's ability to manage the marital assets wisely versus the need for investment guidance.

- The need for creditor protection.

- The need to protect the inheritance of other family members.

[1] Where the surviving spouse is not a U.S. citizen, in order to qualify for the marital deduction, property must pass into a special type of trust called a qualified domestic (QDT) trust.

Marital Trusts

The trust must meet requirements established in the Internal Revenue Code to qualify for the unlimited marital deduction. Generally, a transfer will not qualify for the marital deduction if the transfer results in a "terminable interest." There are three exceptions to the terminable interest rule: (1) a power of appointment trust, (2) an estate trust, and (3) a qualified terminable interest property trust (QTIP).

- **The Power of Appointment Trust.** A power of appointment trust is a marital trust in which the surviving spouse is entitled to income for life, payable at least annually, and the surviving spouse has a general power of appointment over the property in the trust. A general power of appointment allows the surviving spouse to give the trust property to whomever he or she desires.

- **An Estate Trust.** An estate trust is one in which the surviving spouse is given an interest for life, with the remainder passing to his or her estate. The advantage of an estate trust is that the income does not have to be paid annually to the surviving spouse. If the trust is in a lower income tax bracket, the trustee can accumulate income within the trust.

- **A Qualified Terminable Interest Property (QTIP) Trust.** The QTIP trust provides a way for a spouse to protect the interests of heirs (perhaps his or her children from a prior marriage) while still providing for the surviving spouse. The grantor spouse can provide that his or her spouse will receive only the income from the property. At the death of the surviving spouse, the property must pass to the person or persons named as trust beneficiaries. This otherwise nondeductible terminable interest qualifies for the marital deduction. The major advantage of a QTIP marital trust to a grantor is, at the surviving spouse's death, the remaining trust property passes to beneficiaries selected by the grantor.

  There are four conditions that must be met before QTIP treatment is allowed:

  - The decedent-spouse must make a transfer of property.
  - The surviving spouse must receive all trust income, payable at least annually, for life.
  - The trust may provide for discretionary principal distributions only to, or for the benefit of, the surviving spouse. No trust income or principal may be diverted from the spouse (by the spouse or others) during the spouse's lifetime.
  - The decedent-spouse's executor must make an irrevocable election on the decedent's federal estate tax return. The election provides that, to the extent the QTIP property has not been consumed during the surviving spouse's lifetime, its value at the death of the surviving spouse will be included in the surviving spouse's estate.

The QTIP trust can provide the following advantages:

- Financial management of assets for a spouse who is not willing to handle, or capable of handling, such matters.
- Protect assets against claims of creditors or claims of a new spouse.
- Permit the deceased spouse to control the ultimate distribution of the trust property, unlike other types of trusts that qualify for the unlimited marital deduction.
- Provide estate tax flexibility. An executor may elect to qualify only part of the QTIP trust property for the unlimited marital deduction and pay some estate tax at the first death. The executor of the deceased spouse's estate will therefore have a second look at the potential overall estate tax savings.

Because of the unlimited marital deduction, there is a tendency to focus only on the advantages of passing wealth between husband and wife free of gift and estate tax. While this may be effective with smaller estates, this approach fails to take into account the ultimate consequences on the combined estates of the spouses where the surviving spouse inherits all the family wealth after the death of the first spouse. In large estates, passing all of the wealth to the surviving spouse under the unlimited marital deduction will potentially result in increased estate tax at the surviving spouse's death. The opportunity to pass significant wealth from the first spouse to other family heirs free of transfer tax through the use of exemptions and exclusions may be reduced or lost.

Credit Shelter Trust

Where a credit shelter trust (CST) is established, the estate is divided into two parts at the death of the first spouse. One part, equal to the applicable exclusion amount, is placed in a trust that generally provides lifetime benefits to the surviving spouse but will bypass his or her estate at death. The other part passes outright to the surviving spouse or is placed in a marital trust for the spouse's benefit. In this way, use of a credit shelter trust can help shelter assets and their appreciation from taxation at the second spouse's death. The result is that no federal estate tax is due when the first spouse dies.

The CST is also known as a "B Trust" or a "Bypass Trust" because assets bypass or are sheltered from inclusion in the surviving spouse's estate. Though the portability rules may appear to reduce the need for a CST, the trust still may enable a married couple to shelter up to two times the applicable exclusion amount from estate tax. The CST can provide extensive benefits to the surviving spouse and still be excluded from his or her estate. These benefits include:

- The surviving spouse may receive all the income from the CST for life.
- A trustee, who may be the surviving spouse, may be given the right to invade trust principal to provide for his or her own health, education, maintenance, and support. Alternatively, an independent trustee may be given virtually unlimited discretion as to the distribution of the trust principal.
- The surviving spouse may have a limited power of appointment to name the beneficiaries who will receive the remaining trust property at his or her death. For this, trust provisions should specify that the trust property cannot be directed to the spouse's estate, creditors of the spouse, or creditors of the estate.
- The CST may have many beneficiaries in addition to, or instead of, the surviving spouse.

IRREVOCABLE LIFE INSURANCE TRUSTS.

Irrevocable life insurance trusts (ILITs) are intended to make the proceeds of life insurance policies available to trust beneficiaries in a manner that will not subject the policy proceeds to unnecessary transfer tax or income tax. When properly drafted, an ILIT can provide lifetime benefits to the grantor's surviving spouse and heirs and be excluded from both taxable estates. Typically, ILITs are used to accomplish four goals:

- To exclude the policy proceeds from the estates of the grantor and his or her surviving spouse.
- To help meet the liquidity needs of the grantor's estate.
- To provide income for the grantor's survivors.
- To shelter property from creditors at death.

ILIT Overview

The ILIT is created during the grantor's life generally for the benefit of family members. The trust is funded with a life insurance policy on the grantor or the grantor and his or her spouse. Usually the trustee acquires a new policy with cash transferred to the trust from the grantor. In order to avoid inclusion of the policy in the grantor's estate for estate tax purposes, the grantor retains no ownership rights, control, or beneficial interest in the trust. Although an existing policy may be transferred to the trust, if the grantor dies within three years of the transfer date, the policy will be included in his or her estate.

To fund the trust, the grantor transfers money to the trust for premium payments, using the annual gift tax exclusion or the gift tax applicable exclusion amount. Limited powers to withdraw the cash transfers (often called Crummey powers) are granted to the beneficiaries to ensure that the transfers of the annual premium amounts qualify for the annual gift tax exclusion.

Advantages

- When the trust is properly structured, the ILIT property, including the life insurance proceeds, is not included in the grantor's taxable estate. For new policies, the trustee should apply for the insurance as the owner. For existing insurance that is transferred to the ILIT, the grantor generally must survive for three years after the transfer for the death benefit to be excluded from the grantor's estate.
- The grantor's spouse may have a limited interest in the trust without causing the insurance proceeds to be included in his or her taxable estate. Note: Using a community property checking account to make gifts to a trust that will benefit the surviving spouse will pull the trust proceeds into the surviving spouse's taxable estate. Care must be taken to keep all gifts separate.
- The trust protects the policy and proceeds against creditors.

Disadvantages

- It is irrevocable. A grantor cannot amend or revoke the trust.
- Grantor loses control over the policy and cannot receive any direct economic benefit from the trust.
- It involves preparation that can be complex and expensive. The trust can be time-consuming to administer.

USE OF THE TRUST TO AVOID GENERATION-SKIPPING TRANSFER TAX.

The generation-skipping transfer (GST) tax was enacted to recoup estate taxes that were lost when property was gifted or bequeathed to an individual described as a skip person. A skip person is someone who belongs to a generation that is two or more generations below that of the transferor or is more than 35 years younger. GST tax may be incurred whether the transfer is made outright or in trust for the benefit of a skip person.

The GST tax is levied at a flat rate that is currently unified ($11,580,000 in 2020) as indexed for inflation and a flat rate of 40% with the gift and estate tax. Often, life insurance is a favorable vehicle to fund a trust that is used for GST purposes. (A complete discussion of the GST tax is beyond the scope of this brochure.)

- **Dynasty Trust (Generation-Skipping Trust)**
  The dynasty trust, also referred to as the "family bank" or a GST trust, is a multi-generational trust (subject to the rule against perpetuities) that, when properly established and administered, can conserve family wealth by preventing inclusion of the assets in the taxable estates of each successive generation.

  The GST tax can be permanently avoided with respect to all benefits derived by succeeding generations through leveraged use of the estate owner's lifetime GST exemption allocations to gifts that are likely to appreciate substantially in value over time.

  Life insurance policies are a favored funding vehicle for leveraging the GST exemption into a potentially multimillion-dollar asset for the benefit of succeeding generations.

USE OF CHARITABLE TRUSTS FOR CHARITABLE GIVING PURPOSES.

Charitable trusts may be established for the sole benefit of a charity or, in the case of split-interest trusts, for the benefit of charities and individual non-charitable beneficiaries. Split-interest trusts provide for a charitable interest that arises either before or after that of the non-charitable beneficiaries. Transfers to certain split-interest trusts qualify for the charitable deduction. If a split-interest trust qualifies as a charitable remainder trust or a charitable lead trust, the donor will be able to claim a charitable deduction for the interest passing to a charity.

- **Charitable Remainder Trusts**
  A charitable remainder trust (CRT) is an irrevocable split-interest trust (created during life or by will) that provides for the income interest to be paid to non-charitable beneficiaries, which may include the grantor, and the remainder interest to be paid to charitable beneficiaries. The income from a CRT may be paid to one or more persons for their joint lives or for a period of time not to exceed 20 years. At the expiration of the income interest, the trust principal (the remainder) passes to the named charity.

  CRTs are commonly used to avoid capital gains tax on highly appreciated property when the property is sold. The appreciated property is transferred to the CRT and subsequently sold by the tax-exempt trust. The proceeds are then generally reinvested to produce an income stream for the donor. A CRT is appropriate for a donor who wishes to benefit a charity in the future, but desires a current charitable deduction and income stream from the property during his or her lifetime.

  When property is contributed to a CRT, the grantor receives a current income tax deduction equal to the present value of the remainder interest. If a person other than the grantor and his or her spouse are the income beneficiaries, the grantor is deemed to have made a gift of a portion of the income interest to these income beneficiaries.

  There are two types of qualifying charitable remainder trusts: a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT). The following illustrates several differences between a CRAT and a CRUT.

- **Charitable Remainder Annuity Trusts**

  - Annual payments of a fixed percentage of the initial fair market value of the contributed property must be made (equal to or greater than 5% and not exceeding 50%).

  - The charitable beneficiary's remainder interest must actuarially equal or exceed 10% of the initial fair market value of all contributed property. A low federal interest rate can make it difficult for trusts with younger beneficiaries to satisfy these requirements.

  - No additional property can be added to the CRAT after the initial contribution.

- **Charitable Remainder Unitrusts**

  - Annual payments of a fixed percentage of the annually valued trust assets must be made (equal to or greater than 5% and not exceeding 50%). If trust assets increase in value, the amount distributed to the income beneficiary increases. If the value of the trust assets decreases, the amount distributed decreases.

  - Annual payments may be limited to the net income of the trust.

  - The charitable beneficiary's remainder interest must actuarially equal or exceed 10% of the fair market value of the contributed property as of the date of the contribution to the trust.

  - Additional property may be added to the CRUT after the initial contribution.]

- **Wealth Replacement Trusts**
  When property is contributed to a CRT, the grantor's heirs, who would have normally been the recipients of the property at the death of the donor, are effectively disinherited. A common strategy to replace this loss is the establishment of an irrevocable life insurance trust often referred to as a "Wealth Replacement Trust." At the death of the donor/grantor, the policy proceeds can be passed to the heirs income and estate tax-free, replacing the value of the asset given to charity. The savings from the charitable income tax deduction and the higher income stream from the CRT may help offset the cost of the life insurance.

- **Charitable Lead Trusts**
  A charitable lead trust (CLT) is an irrevocable split-interest trust (created during life or by will) that provides for the income interest to be paid to a charity with the trust principal (remainder interest) passing to non-charitable beneficiaries when the trust terminates.

  Like a charitable remainder trust, the income interest in a CLT can be either an annuity interest or a unitrust interest. In a charitable lead annuity trust (CLAT), the income interest is a fixed dollar amount every year. In a charitable lead unitrust, the income is a fixed percentage of the value of the trust's assets. The assets are valued every year and, if the value increases, the distribution to the charity increases and vice versa.

  A current income tax deduction is allowed only if the CLT is structured as a grantor trust. However, CLTs are generally used to achieve estate tax savings rather than income tax savings and are structured as non-grantor trusts or created at death after a basis step-up.

Generally, to reduce gift and estate taxes when passing property to family members, a CLT is structured as a non-reversionary lead trust. The grantor funds the CLT with income-generating property, providing the charity with guaranteed annual income payments, based on the fair market value of the trust, for a period of time. At the end of the specified period, the remainder interest passes to the grantor's family members or other non-charitable beneficiaries. If someone other than the grantor is the remainder beneficiary, then a portion of the assets will not be included in the grantor's estate. However, in this case, the grantor has made a gift of the remainder interest to the remainder beneficiary. The annual gift tax exclusion cannot be applied toward this gift of a remainder interest because it is not a gift of a present interest in property. However, the value of the gift may be discounted for gift tax purposes.

If the remainder beneficiaries are expected to be skip individuals, there are generation-skipping issues and a CLAT should be used in place of a CLUT. In determining the value of the trust's remainder interest for GST tax purposes, the CLAT is valued as of the date of original contribution, whereas the CLUT is valued as of the date of distribution. Assuming growth over the years, the CLUT will create a much greater "unknown" GST tax exposure.

USE OF FUTURE INTEREST TRUSTS.

Charitable split-interest trusts are feasible for individuals who are willing and able to transfer assets to charity. However, many grantors are unwilling to give away substantial property during their lifetime. Although they ultimately want to see the assets pass to their heirs, they want to retain control during their lifetime.

For these individuals, the solution may be the use of split-interest trusts that allow them to retain a beneficial interest in gifted property for a period of time and ultimately pass the remainder interest to their heirs. Because the heirs do not receive the trust assets until a date sometime in the future, these trusts are often called "future interest trusts." With these trusts, older family members can pass assets with growth potential to younger family members with minimal federal gift taxes. The value of the transferred asset minus the value of the interest retained by the grantor will equal the value of the remainder interest gift. The gift of the remainder interest is considered a "future gift" and does not qualify for the annual gift tax exclusion. Therefore, a part of the grantor's gift tax applicable exclusion amount must be consumed. It is important to note that if the grantor dies before the trust terminates and distributes the property to the remainder beneficiaries, the entire trust assets will be included in the grantor's taxable estate.

Non-charitable future interest trusts:

- Grantor retained annuity trust (GRAT);
- Grantor retained unitrust (GRUT); and a
- Qualified personal residence trust (QPRT).

Grantor Retained Annuity Trust (GRAT)

A grantor retained annuity trust (GRAT) is an irrevocable trust to which the grantor transfers property, while retaining a right to a fixed annuity interest for a set period of time (not to exceed life expectancy), with the remainder interest passing to a remainder beneficiary. Distributions must occur at least annually and are equal to a set percentage of the value of trust assets as of the date the property is placed in trust and may never vary.

[**Grantor Retained Unitrust (GRUT)**
A grantor retained unitrust (GRUT) is very similar to the GRAT described above. The chief difference is in the method used to calculate the amount of the trust payments made to the grantor. A unitrust's interest is calculated by multiplying the value of the trust assets, as determined annually on a prescribed valuation date, by a set percentage. This allows for variable payments to be made to the grantor. If the value of trust assets increases, the amount of the distribution to the grantor increases. Correspondingly, if the value of the trust property decreases, the distribution decreases.

Generally, the GRUT is not as popular as the GRAT, especially in periods of low interest rates.]

- **Qualified Personal Residence Trust (QPRT)**
A qualified personal residence trust (QPRT) is an irrevocable trust in which the right retained by the grantor is generally the right to live in the residence for a fixed term of years. It is very similar to a GRAT except there is no cash payment paid back to the grantor.

LOOKING TO THE FUTURE.

As you can see, there are many types of trusts that can be used as part of an individual's estate. Individuals will continue to need to consider non-tax reasons for the use of trusts.

These non-tax reasons include ensuring that assets pass to the intended beneficiaries at the time and in the manner desired, and the need in many cases to protect the assets passing to beneficiaries from creditors. In such an environment, trusts will still provide significant benefits.

Individuals should consult with a financial professional for more information on how life insurance, in combination with trusts, can be used to help protect those they love.