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Irrevocable Trusts

By David A. Solitare

This article describes how an irrevocable trust can be useful in achieving your estate planning goals, and the drawbacks of such trusts. Fortunately, or unfortunately, there are many types of irrevocable trusts and they are used for many purposes. For ease of discussion, I will group them into two classes, which I will call "permanent" trusts and "split interest" trusts.

Permanent trusts are designed for the prolonged management of permanently and irrevocably transferred assets. The objectives of this type of trust include:

- Immediate removal of the transferred property from the settlor's (the person who sets up the trust) estate for *estate* tax purposes, often accomplished at the cost of making a gift for *gift* tax purposes.
- Elimination of income generated by trust assets from the settlor's income for *income* tax purposes. Trusts for minors and life insurance trusts, which I will discuss further below, are specialized forms of permanent trusts.

Split interest trusts are established to provide income to one set of beneficiaries for a set time, then pay out to another set of beneficiaries. For example, charitable remainder trusts are designed to provide benefits to named individuals, such as the settlor's family, for a specified period of time, with the remainder interest passing to charity. The objectives of this type of trust include removing the transferred assets from the settlor's estate for estate tax purposes, and receiving a charitable deduction on the settlor's income tax return.

Another class of split interest irrevocable trusts, known as grantor retained income trusts, is designed to minimize taxes by incurring a gift tax only for the remainder interest which follows a settlor's retained interest. If this sounds obtuse, you can read more about GRITs below.

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Let me now describe for you in brief three or four of such techniques which you may want to consider. Please note that a complete analysis of each technique is impractical here, but I will be happy to answer any questions you may have about any of them that interest you.

Irrevocable Life Insurance Trust

The principal advantage of using an *inter vivos* (living) irrevocable life insurance trust ("ILIT") is that it may keep the life insurance policy proceeds from being taxed as part of the estates of both the insured and the insured's spouse, while allowing the insured's surviving spouse to enjoy the benefits of the proceeds as a trust beneficiary. The surviving spouse may be entitled to all or a portion of the income and/or the insurance policy proceeds, in the discretion of a trustee other than the spouse, without causing the proceeds to form part of the surviving spouse's gross estate. The surviving spouse also may have the right to demand some of the proceeds for his or her support, maintenance, education, and health, limited by an ascertainable standard.

Alternatively, the surviving spouse may be given the power to demand the greater of $5,000 or 5% of the value of the trust each calendar year, without subjecting any portion of the insurance proceeds to tax in the survivor's estate, except for the portion subject to the withdrawal power in the year of the survivor's death.

Potential advantages include:

- ♦ Estate tax savings.
- ♦ The life insurance proceeds may not be subject to the claims of creditors under applicable law.
- ♦ The trust arrangement may provide significant protection from the claims of the insured's spouse. For example, having the insurance proceeds payable to a trust may protect the proceeds from any state law elective share right of a surviving spouse; such an elective share right, if exercised, could potentially inflict substantial damage to the carefully crafted estate plan.
- ♦ A trust provides a flexible tool for the management and distribution of assets. It provides a "ready-made" asset management vehicle which may be crafted as flexibly as the settlor designs the arrangement.
- ♦ The goals for which the insurance was acquired may be advanced by the ownership and receipt of the insurance proceeds by a trust. For example, if the insurance proceeds are to provide liquidity for the insured's estate for the payment of debts, expenses of administration, and taxes, then this goal generally can be achieved by authorizing the trustee to purchase assets from or make loans to the insured's estate or the beneficiaries. Moreover, this goal may be more easily accomplished by trust ownership of the policy because the proceeds may not be subject to estate tax.

Thus, there are circumstances under which the ownership of a life insurance policy by an irrevocable trust, instead of individually, is more beneficial. The tax savings of excluding, for example, $500,000 of life insurance proceeds from the estate of the second to die could be as much as $245,000. Although the ILIT provides this significant estate tax savings opportunity, it presents some distinct drawbacks. Disadvantages include:

- ♦ The insured's loss of control over the policy, including the right to borrow against or otherwise use the cash value of the policy, to designate settlement options, and to change beneficiaries of the policy. This loss of control can be significant, both psychologically and economically.
- ♦ The settlor cannot alter or amend the trust beneficiary designations. However, appropriate drafting of the trust instrument can reduce the impact of these drawbacks.
- ♦ Costs associated with drafting and funding the ILIT. Besides the legal costs, if a professional trustee is selected, there will be trustee's fees.

Charitable Remainder Trust

A charitable remainder trust ("CRT") is an irrevocable trust that pays the settlor, the settlor's spouse or children, an annual income for a period of years or for life. The annual income can be in the form of either an annuity, *i.e.*, a fixed sum annually, or a unitrust amount, which is a fixed percentage of the trust assets valued annually. Thus, the two flavors of charitable remainder trust are the charitable remainder annuity trust ("CRAT") and the charitable remainder unitrust ("CRUT"). The remaining property goes to the charity of the settlor's choice at the end of the trust term and the settlor receives a charitable deduction.

The advantages of the CRT are as follows:

- Appreciated assets can be sold by the trust, reinvesting the proceeds, while avoiding capital gains tax
- The settlor receives an income stream for a term of years or for life
- The settlor claims a charitable deduction on his/her income tax return
- The contributed assets are removed from the settlor's estate, so there is no estate tax liability on such assets; lifetime unified estate/gift tax exemption is not reduced.

A CRUT can also be used to provide for the settlor's retirement needs. Because a CRUT may be structured to pay the lesser of the fixed percentage of the trust assets valued annually or the annual income of the trust, a choice of investments can add to its usefulness. In its initial years — the settlor's preretirement years — the trust invests in high-growth, low-income assets. On the settlor's retirement, the trustee can convert the trust assets to high-income investments to provide the settlor with income. During the early stage, the trust presumably earns little or no income and there is little or no required payout. At retirement, a "make-up" provision in the CRUT allows the trustee to pay out additional amounts of the trust's income (in years when the income exceeds the fixed percentage) to "make up" for the early low-income, pre-retirement years when the fixed percentage was not distributed.

Additionally, a CRT can be combined with an ILIT to provide estate tax-free wealth replacement. That is, through a combination of income tax savings and increased cash flow from the CRT, the settlor can fund an ILIT with additional premiums. The additional premiums can purchase additional life insurance, which will partially or possibly even entirely offset the heirs' loss of the principal given to the charity.

Grantor Retained Income Trust

A grantor retained income trust, or "GRIT," is an irrevocable trust to which the settlor (*i.e.*, "grantor") transfers assets while retaining an income interest for a term of years selected by the settlor. Upon expiration of the term, the trust usually terminates and the remaining balance of the assets transferred to the trust, including any undistributed income and appreciation, is distributed to third parties selected by the settlor, usually his or her children, called remainder beneficiaries.

A GRIT is used to reduce gift taxes on the transfer of assets to the next generation. It is best used with highly appreciating assets, including closely-held stock. The value of the gift is determined when the trust is funded, so any appreciation of the assets passes gift tax-free to the remainder beneficiaries. However, the funding of the GRIT is a taxable gift by the settlor to the remainder beneficiaries; the amount of the gift is determined by reference to IRS actuarial tables that fluctuate monthly depending upon the prevailing federal interest rates.

The principal advantages of a GRIT include:

- Appreciation of the assets is moved out of the estate and avoids gift tax.
- Compared with a direct gift, transfer costs (*i.e.*, gift tax) are greatly reduced, because a taxable gift is made only to the extent that the value of the assets at the time of the transfer exceeds the actuarial value of the retained income interest.
- Compared with a direct gift, the settlor maintains control of the assets for a longer period.
- The settlor retains some or all of the income from the transferred assets for the term of the GRIT.
- So long as the settlor survives the term of the GRIT, the assets used to fund the GRIT are not taxed in the settlor's estate on his/her subsequent death.

Three cautions apply to a GRIT, however.

1. First, if the settlor dies during the trust term, all or most of the trust assets would be includable in the settlor's estate, thus failing to achieve the benefits of the transaction while incurring the transaction costs. The trust term must be carefully selected to provide a great likelihood that the settlor will outlive the term of the trust.
2. This leads to the second caution, which is that the settlor will (or should) lose the economic benefit of the assets during his or her remaining lifetime.
3. Furthermore, the transaction will not provide a benefit if the assets do not outperform the IRS discount rate, currently about 5%.

Qualified Personal Residence Trust

A Qualified Personal Residence Trust ("QPRT") is a type of GRIT which provides an opportunity for significant estate and gift tax savings for taxpayers with substantial equity in their principal residences and vacation homes. The settlor transfers his or her personal residence to the QPRT, which is an irrevocable trust, retaining the exclusive use of the residence for a term of years selected by the settlor. If the settlor survives the term of the trust, the QPRT terminates and the residence is either retained in further trust for, or distributed to, one or more third party beneficiaries selected by the settlor, such as the settlor's children or grandchildren.

The QPRT has no income tax consequences during the term of the trust. The settlor may still use the principal residence capital gain exclusion and deduct mortgage interest and property taxes. Transferring the property to the trust will not trigger a property tax reassessment, although the termination of the settlor's retained interest would trigger a reassessment unless the parent-child transfer exclusion applies. During the term of the trust, the settlor may sell the house and purchase a replacement residence. If the residence sold is not replaced, the QPRT pays an annuity to the settlor.

The "catch" is that after the term of the trust, the settlor will no longer have the right to live in the residence. At this point, the settlor could lease the residence for fair rental value from the beneficiaries. However, the IRS will closely scrutinize such a leaseback transaction. It may contest the validity of the QPRT if the settlor leases the residence upon expiration of the term of the trust and pays less than fair rent, and seek to include the property in the settlor's taxable estate at his or her subsequent death.

The principal advantages of a QPRT are as follows:

- ♦ Appreciation of the residence's value is moved out of the estate and avoids gift tax
- ♦ Compared with a direct gift, transfer costs (*i.e.*, gift tax) are greatly reduced, because a taxable gift is made only to the extent that the value of the residence at the time of the transfer exceeds the actuarial value of the retained income interest plus the value of the contingent reversion
- ♦ The settlor retains the right to use the residence for the term of the QPRT
- ♦ So long as the settlor survives the term of the QPRT, the value of the residence is not taxed in the settlor's estate on his/her subsequent death.

Three cautions apply to a QPRT, however.

1. If the settlor dies during the trust term, the full value of the residence would be includable in the settlor's estate, thus failing to achieve the benefits of the transaction while incurring the transaction costs. The trust term must be carefully selected to provide a great likelihood that the settlor will outlive the term of the trust.
2. This leads to the second caution, which is that the settlor will (or should) lose the right to use his or her home during his or her remaining lifetime.
3. Furthermore, any mortgage principal payments made by the settlor during the term of the trust, and the value of any improvements made to the residence during the trust term, would be treated as additional taxable gifts to the beneficiaries. Therefore, the settlor should pay off any encumbrances before transferring property to a QPRT, if feasible.

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This article is intended to give you enough information to decide which of these estate planning tools might be appropriate, and which are definitely not. We can then discuss further how the ones in which you remain interested may be tailored to meet your goals.